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Rebalancing Copyright Exhaustion

Guy A. Rub

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REBALANCING COPYRIGHT EXHAUSTION

Guy A. Rub*

ABSTRACT

In 2013, in Kirtsaeng v. John Wiley & Sons, Inc., the Supreme Court wrote another chapter in the ongoing story of copyright exhaustion. This ruling is part of a vibrant discourse and a series of recent decisions in high-profile cases, domestically and internationally, regarding the scope of copyright exhaustion and, more broadly, the ability of copyright owners to control the distribution of their work along the chain of commerce. Unfortunately, this discussion rarely explores the modern justifications for copyright exhaustion, which makes it notoriously incoherent and confusing.

This Article suggests that copyright exhaustion serves an important social function of reducing information costs. Without it, buyers will need to inefficiently waste resources inquiring whether they will be able to resell copyrighted work. Because resale rights are typically socially desirable, the law should usually provide those rights to buyers. Copyright exhaustion also has costs. The main costs are the reduction in the incentives to create and a regressive distributive effect that are the result of the limitations that copyright exhaustion places on certain price-discrimination practices. The balance between these benefits and costs should dictate the scope of copyright exhaustion.

This Article applies this balanced approach and explores the desired scope of copyright exhaustion. It concludes, inter alia, that it should not prevent copyright owners from exercising control over commercial importation of copyrighted goods or over distribution of digital work. However, contracting around copyright exhaustion should be restricted, and copyright owners

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should not be allowed to circumvent it just by including “magic words” in their standard-form agreements.

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INTRODUCTION

When can copyright owners control the distribution of their works along the chain of commerce? Can John import a CD of copyright-protected music he purchased in Thailand to the United States, or does he need to secure permission from the copyright owner to do so? Once the CD is in the country, can John sell it on eBay? Can Clarence, who purchased the CD from John, resell it to Ruth? Can Ruth rent it to Elena? How do the answers to these questions differ if instead of buying a physical CD, John would have purchased a digital album on iTunes?

In recent years, these and similar highly controversial questions have been the subject of several high-profile cases, including three that reached the United States Supreme Court.¹ Answering these questions requires courts and litigants,² as well as federal agencies,³ international negotiators,⁴ and scholars⁵ to address the exact scope of the doctrine of copyright exhaustion.⁶

The core principles of copyright exhaustion—also known as “the first sale doctrine”—are easy to grasp. Copyright exhaustion, whose principles are presented in Part I, is the doctrine that balances the interests of owners of copyright and the interests of the owners of copies in which the copyrighted

¹ *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351 (2013); *Costco Wholesale Corp. v. Omega, S.A.*, 562 U.S. 40 (2010) (per curiam) (mem.); *Quality King Distrib., Inc., v. L'anza Research Int'l, Inc.*, 523 U.S. 135 (1998).

² See, e.g., *Kirtsaeng*, 133 S. Ct. 1351; *Costco*, 562 U.S. 40; *Quality King*, 523 U.S. 135; *UMG Recordings, Inc. v. Augusto*, 628 F.3d 1175 (9th Cir. 2011); *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010).

³ See, e.g., INTERNET POLICY TASK FORCE, DEP'T OF COMMERCE, COPYRIGHT POLICY, CREATIVITY, AND INNOVATION IN THE DIGITAL ECONOMY 35–37 (2013), available at <http://www.uspto.gov/news/publications/copyrightgreenpaper.pdf> [hereinafter COPYRIGHT IN THE DIGITAL ECONOMY] (a report of the Department of Commerce regarding the distribution of digital work).

⁴ In recent years, international free trade agreements typically address the rights of copyright owners to control importation of their work. See Margot E. Kaminski, *The Capture of International Intellectual Property Law Through the U.S. Trade Regime*, 87 S. CAL. L. REV. 977 (2014).

⁵ See, e.g., Richard A. Epstein, *The Disintegration of Intellectual Property? A Classical Liberal Response to a Premature Obituary*, 62 STAN. L. REV. 455, 501–09 (2010); Aaron Perzanowski & Jason Schultz, *Digital Exhaustion*, 58 UCLA L. REV. 889 (2011); Glen O. Robinson, *Personal Property Servitudes*, 71 U. CHI. L. REV. 1449 (2004); Molly Shaffer Van Houweling, *The New Servitudes*, 96 GEO. L.J. 885 (2008).

⁶ The equivalent doctrine in patent law—patent exhaustion—has also been subject to extensive discussion in recent years, including in two prominent cases that were decided by the Supreme Court. *Bowman v. Monsanto Co.*, 133 S. Ct. 1761 (2013); *Quanta Computer, Inc. v. LG Elecs., Inc.*, 553 U.S. 617 (2008). While this Article focuses on copyright exhaustion, most of its analysis is applicable, with appropriate adjustments, to patent exhaustion as well.

work is embodied.⁷ Specifically, this doctrine provides that once copyright owners transfer ownership in copies of their works, their rights to control future distribution of those copies is exhausted.⁸ The buyers are therefore free to transfer the copies as they please.

Unfortunately, applying this doctrine in our global village and the digital world, in which copies can easily move between countries and work can be copied and distributed exceedingly fast, both physically and digitally, is challenging. This challenge is exacerbated because copyright exhaustion is under theorized. Indeed, many judges and commentators take the principles of copyright exhaustion and their ancient justifications as a given without questioning them.⁹ As one scholar noted, copyright exhaustion is “one whose justification is still underdeveloped despite a century of mechanical recitation.”¹⁰

This Article tackles this difficulty by reexamining the justifications for the norms of exhaustion in light of modern developments in technology, in other areas of the law, and in economics. It concludes that copyright exhaustion is justified as a tool to reduce information costs in markets for copyrighted goods. However, this socially desirable goal should be weighed against the reduction in incentives to create, and a possible regressive distributive effect that copyright exhaustion causes. This balance should dictate the scope of copyright exhaustion. This Article also rejects other possible justifications for the doctrine as either unconvincing or insignificant.

⁷ See Aaron Perzanowski & Jason Schultz, *Copyright Exhaustion and the Personal Use Dilemma*, 96 MINN. L. REV. 2067, 2107–09 (2012).

⁸ 17 U.S.C. § 109(a) (2012).

⁹ Even those few commentators who address the justifications for copyright exhaustion typically take extreme views. Compare Epstein, *supra* note 5, at 502–03, Herbert Hovenkamp, *Post-Sale Restraints and Competitive Harm: The First Sale Doctrine in Perspective*, 66 NYU ANN. SURV. AM. L. 487 (2011), and Robinson, *supra* note 5 (all questioning whether there is any general justification for copyright exhaustion), with Perzanowski & Schultz, *supra* note 5, and R. Anthony Reese, *The First Sale Doctrine in the Era of Digital Networks*, 44 B.C. L. REV. 577 (2003) (all providing a list of unquestionable benefits to copyright exhaustion). This Article advocates for a more balanced approach.

¹⁰ Robinson, *supra* note 5, at 1479; see also Molly Shaffer Van Houweling, *Touching and Concerning Copyright: Real Property Reasoning in MDY Industries, Inc. v. Blizzard Entertainment, Inc.*, 51 SANTA CLARA L. REV. 1063, 1064 (2011) (“[T]he exhaustion concept is fuzzy around the edges and frustratingly under-theorized . . .”).

Copyright exhaustion emerged in the early twentieth century.¹¹ As explained in Part II, at the time of its emergence, copyright exhaustion was rationalized, to a large degree, by several related principles: the common law refusal to recognize servitudes on chattels, its bar on almost all restraints on alienation of property, and, above all, the antitrust policy that prohibited practically all vertical restraints.¹² However, our views of those principles have changed during the last century, mainly because modern sophisticated economic models questioned their justifications and broad application.¹³ Development in the law followed, and these doctrines are no longer strictly applied but instead are subject to a rule of reason test.¹⁴ Therefore, those principles, which are now narrower and more flexible, can no longer justify the broad and strict doctrine of copyright exhaustion. Unfortunately, some courts and commentators, including recently the Supreme Court, continue to rely on those ancient principles.¹⁵ This continued reliance on historic principles that are too weak to justify copyright exhaustion nowadays makes the doctrine incoherent and confusing, and, more troubling, can prevent it from promoting desirable social goals.

Part III explores the effects of copyright exhaustion on the famous incentives–access tradeoff. It suggests that from that perspective copyright exhaustion might be socially costly. The facts of the recent Supreme Court decision in *Kirtsaeng v. John Wiley & Sons, Inc.* can illustrate this effect. The defendant in this case earned significant amounts of money by purchasing textbooks in Thailand and selling them in the United States.¹⁶ In doing so, he took advantage of the copyright owner’s decision to engage in price

¹¹ The doctrine was created in *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339 (1908), and was codified a year later in the Copyright Act of 1909, ch. 320, § 41, 35 Stat. 1075, 1084 (later codified as 17 U.S.C. § 41 (1926) (repealed 1976)).

¹² See, e.g., Robinson, *supra* note 5, at 1470.

¹³ See Hovenkamp, *supra* note 9, at 514–15.

¹⁴ See, e.g., Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007) (applying a rule of reason to resale minimum price arrangement); Robinson, *supra* note 5, at 1456–58 (exploring twentieth century cases in which courts enforced servitudes on chattels); Joseph William Singer, *The Rule of Reason in Property Law*, 46 U.C. DAVIS L. REV. 1369, 1410 (2013) (restraints on alienation of property are subject to an unreasonableness test); see also RESTATEMENT (THIRD) OF PROPERTY (SERVITUDES) § 3.4 (2000) (“A servitude that imposes a direct restraint on alienation . . . is invalid if the restraint is unreasonable.”).

¹⁵ *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1363 (2013) (“The ‘first sale’ doctrine is a common-law doctrine with an impeccable historic pedigree.”).

¹⁶ *Kirtsaeng*, 133 S. Ct. at 1375 (Ginsberg, J., dissenting) (“[K]irtsaeng imported and then sold at a profit over 600 copies of copyrighted textbooks . . .”); *John Wiley & Sons, Inc. v. Kirtsaeng*, 654 F.3d 210, 215 (2d Cir. 2011) (noting that Kirtsaeng admitted to earning \$900,000 in revenues while the plaintiff’s counsel suggested that his revenues were \$1.2 million).

discrimination and sell books in Thailand for a fraction of their price in the United States.¹⁷ Therefore, when the Supreme Court held that copyright exhaustion applies to Kirtsaeng's actions and thus they did not constitute copyright infringement, it also held that the publisher's ability to engage in international price discrimination is limited.

While the Supreme Court did not seem to be troubled by this *de facto* limitation on price discrimination,¹⁸ this Article suggests that from a policy perspective, restricting this type of a pricing scheme is likely undesirable. This restriction is expected to reduce the incentives to create, in many cases, maybe most, without improving access to the work.

Part IV considers other possible modern justifications for copyright exhaustion and finds them unconvincing or too weak to support the broad scope of the doctrine. It is shown that copyright exhaustion does not increase the level of spillovers from the distribution of copyrighted work but in fact might shrink them, which is socially harmful. Correspondingly, it also might create an undesirable regressive distributive effect by transferring wealth from the typically poorer to the typically richer buyers. In addition, copyright exhaustion is not a required condition for having vibrant markets in which copyrighted works are resold and shared. In fact, modern markets in which copyrighted works are being distributed in innovative ways have emerged and proliferated in recent years, even where copyright exhaustion is inapplicable, such as in the digital world. Netflix streaming, iTunes, Amazon's Kindle, and Pandora are just a few examples of this trend. Other important social goals, including the preservation of old copyrighted goods or the protection of buyers' privacy, cannot justify copyright exhaustion as well because the linkage between them and its scope is too feeble. Copyright exhaustion applies in many situations in which neither preservation nor privacy are concerned and

¹⁷ See *Kirtsaeng*, 133 S. Ct. at 1356. Price discrimination in information goods was subject to extensive discussion in copyright literature in recent years. See, e.g., William W. Fisher III, *When Should We Permit Differential Pricing of Information?*, 55 UCLA L. REV. 1 (2007); Randal C. Picker, *From Edison to the Broadcast Flag: Mechanisms of Consent and Refusal and the Propertization of Copyright*, 70 U. CHI. L. REV. 281 (2003); Guy A. Rub, *Contracting Around Copyright: The Uneasy Case for Unbundling of Rights in Creative Works*, 78 U. CHI. L. REV. 257 (2011).

¹⁸ See, e.g., *Kirtsaeng*, 133 S. Ct. at 1370; *Quality King Distribs., Inc., v. L'anza Research Int'l, Inc.*, 523 U.S. 135, 151 (1998) (suggesting that copyright exhaustion should be interpreted broadly because a prohibition on unlicensed importation "would merely inhibit access to ideas without any countervailing benefit." (quoting *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 450-51 (1984)) (internal quotation marks omitted)).

does not apply in many cases that are crucial to the promotion of those desirable social goals.

Copyright exhaustion creates important social benefits as well. The main benefit, explored in Part V, is a reduction in information costs. The doctrine helps to create a reasonably clear standard set of rights that buyers receive when they buy copyrighted goods. Because those rights are important in the buyers' buying decision, without copyright exhaustion, they would need to waste resources in verifying their rights, which is inefficient. Part V further explains that without copyright exhaustion some markets will include a mix of copyrighted goods that can and cannot be resold, and that in such a case, if the buyers cannot easily distinguish between the various goods, those markets might significantly shrink. This phenomenon, which economists call "the market for lemons,"¹⁹ might be especially devastating to domestic resale markets such as eBay. Finally, Part V suggests that these information costs might affect laypersons significantly more than professional repeat buyers.

Part VI shows how those identified costs and benefits can help answer several of the open questions regarding the scope of copyright exhaustion. This Part demonstrates how reshaping—or rebalancing—the scope of copyright exhaustion can efficiently lower the cost and increase the benefits of copyright exhaustion. First, the analysis suggests that because of the differences in the economic characteristics of domestic and international markets, the law should treat importation and domestic resale differently. This Article thus suggests that while copyright exhaustion should be broadly applied in domestic markets, allowing the copyright owner to exercise control over importation, a regime called national exhaustion (or, in its weaker form, regional exhaustion), is supported by sound economic reasoning. The analysis thus provides a strong policy support to a position taken in Justice Kagan's concurring opinion in *Kirtsaeng*.²⁰

Second, copyright exhaustion should not be extended to digital works.²¹ Because digital files can typically be easily and indefinitely transferred, an

¹⁹ See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

²⁰ *Kirtsaeng*, 133 S. Ct. at 1372–73 (Kagan, J., concurring). This opinion, which implicitly calls for reversing the Supreme Court's precedent set in *Quality King*, was joined by Justice Alito. See *id.*; see also Guy A. Rub, *The Economics of Kirtsaeng v. John Wiley & Sons, Inc.: The Efficiency of a Balanced Approach to the First Sale Doctrine*, 81 FORDHAM L. REV. RES GESTAE 41, 52–53 (2013) (advocating the same).

²¹ See *Capitol Records, LLC v. ReDigi, Inc.*, 934 F. Supp. 2d 640, 654–56 (S.D.N.Y. 2013) (holding that the principles of copyright exhaustion do not apply to digital work). This position is inconsistent with the

unrestricted right to do so may potentially cause significant harm to the market of copyright owners and substantially reduce the quantities they are able to sell. The market for digital works might not be experiencing a high-information-costs problem, and it is innovative and fast growing without the need to mandate a legal right to transfer digital works.

Third, this Article questions whether allowing commercial for-profit renting of copyrighted works, which might be a unique feature of U.S. law,²² is socially desirable. In contrast, a policy that allows public not-for-profit libraries to freely lend copyrighted goods, which is common in many jurisdictions,²³ might be economically justified.

Fourth, this Article explores whether parties should be allowed to contract around the rules of copyright exhaustion.²⁴ This is an exceptionally complex question. This Article concludes that contractual provisions that are inconsistent with the rules of copyright exhaustion should be enforced when they are included in negotiated contracts, but they should be subject to legal scrutiny when they are part of standard-form agreements.

Finally, this Article addresses the distinction between a sale and a mere license. Under current law, only a sale triggers copyright exhaustion,²⁵ but distinguishing between transactions that are sales and those that are not is difficult and highly controversial. This Article argues that when the economic realities of a transaction clearly indicate that title was not transferred, limiting copyright exhaustion might make sense. In contrast, it is inefficient to allow copyright owners to circumvent the rules of copyright exhaustion by including certain language—“magic words”—in their standard-form agreements that categorizes a transaction that looks like a sale as a mere license. This Article

position of the European Court of Justice, *see* Case C-128/11, *UsedSoft GmbH v. Oracle Int'l Corp.*, 2012 E.C.R. I-0000, *available at* <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:62011CJ0128>, and with the views of several scholars, *see, e.g.*, Clark D. Asay, Kirtsaeng and the First-Sale Doctrine's Digital Problem, 66 STAN. L. REV. ONLINE 17 (2013); Perzanowski & Schultz, *supra* note 5; *cf.* Eugene Volokh, *The Future of Books Related to the Law?*, 108 MICH. L. REV. 823, 830–32 (2010) (suggesting that controlling digital distribution will allow publishers to offer better terms).

²² 17 U.S.C. § 109(a) (2012); *cf.* Directive 92/100, on Rental Right and Lending Right and on Certain Rights Related to Copyright in the Field of Intellectual Property, 1992 O.J. (L 346) 61 (EC) [hereinafter Rental Directive] (granting copyright owners an exclusive right to commercially rent and lend copyrighted works).

²³ *See, e.g.*, Rental Directive, *supra* note 22, art. 5, at 63–64.

²⁴ This issue is part of a broader discussion regarding the legality of contracting around core doctrines in copyright law. *See, e.g.*, MARGARET JANE RADIN, *BOILERPLATE: THE FINE PRINT, VANISHING RIGHTS, AND THE RULE OF LAW* 168–73 (2013); Mark A. Lemley, *Beyond Preemption: The Law and Policy of Intellectual Property Licensing*, 87 CALIF. L. REV. 111, 118–33 (1999); Picker, *supra* note 17; Rub, *supra* note 17.

²⁵ 17 U.S.C. § 109(d).

thus provides support to the approach of the Second Circuit,²⁶ which focuses on the economic realities of the transaction, and rejects the approach of the Ninth Circuit, which formally focuses on the language of the contract between the parties.²⁷

I. ON COPYRIGHT EXHAUSTION

A. *Copyright Exhaustion in Context*

Anne publishes a book she wrote and sells a copy of it to Ben. Several sets of legal rules govern this transaction.²⁸ First, the transaction between the parties is a contract for the sale of goods, and therefore, it triggers the default rules that are part of contract law, as well as the parties' additional agreed upon terms. The transaction involves the transfer of ownership and possession of the copy, and thus it is also governed by personal property law. Article 2 of the Uniform Commercial Code deals with certain aspects of such transactions under both contract law and property law.²⁹

Typically, upon the completion a transaction for the sale of goods, title in the goods passes to the buyer, Ben, and he can then do with them almost whatever he pleases, including transferring them to others. However, when the goods in question are protected by intellectual property rights, the nature of the transaction changes and the buyer's rights are more limited. Certain actions are prohibited by intellectual property law. Those actions are referred to as the exclusive rights, and, by default, these rights are not transferred to a buyer of items protected by intellectual property rights.

If the goods are subject to copyright law protection, the exclusive rights include, among other things, the right to reproduce the good, the right to distribute it, and the right to publically perform and display it.³⁰ Indeed, while the buyer of a piece of furniture can present it in public, the buyer of a

²⁶ See, e.g., *Krause v. Titleserv, Inc.*, 402 F.3d 119 (2d Cir. 2005).

²⁷ See, e.g., *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010).

²⁸ The set of legal rules mentioned in this paragraph is of course incomplete. The transaction can trigger legal principles that are parts of other areas of the law: the publishing of a book, for example, is affected by environmental law, labor law, and corporate law; the transaction between Anne and Ben is a tax event, and so on.

²⁹ While Article 2 is typically considered to be part of contract law, some parts of it deal with certain property law aspects of transactions for the sale of goods. For example, U.C.C. §§ 2-401 to 2-403 (2014), deal with the transfer of title in those transactions.

³⁰ 17 U.S.C. § 106.

copyrighted painting might not enjoy the same right.³¹ The exclusive rights thus create a tension between the rules governing personal property and intellectual property law.³² Copyright law deals with this tension and balances the conflicting interests through the doctrine of copyright exhaustion, which is also known as the first sale doctrine.³³

Under this doctrine, currently codified in Section 109(a) of the Copyright Act, the owner of a copy of a protected work (e.g., a book or a CD) has the right to transfer that copy to others.³⁴ Thus, this doctrine significantly weakened the control that copyright owners enjoy over the distribution of copies of their works.

B. A Comparative Look at the Scope of Copyright Exhaustion

In recent years, courts and commentators have struggled with questions regarding the scope of copyright exhaustion. For example, in 2013, the Supreme Court addressed a circuit split regarding the scope of the doctrine with respect to copyrighted goods that are manufactured abroad and imported into the United States.³⁵ Lower courts and commentators, as well as the U.S. Copyright Office and the Internet Policy Task Force within the Department of Commerce, currently struggle with a host of other issues, such as whether the doctrine applies to digital works³⁶ and when a seller can continue to exercise control over future distribution of a work by classifying transactions as mere licenses instead of sales.³⁷ The decisions on these issues are expected to affect billions of dollars of sales.³⁸

³¹ Copyright owners have an exclusive right to control public display of their works. *Id.* § 106(5). However, in some cases this right is exhausted and limited. *Id.* § 109(c). Analyzing the part of the exhaustion doctrine that limits copyright owners' ability to control the public display of their works is beyond the scope of this Article.

³² See Van Houweling, *supra* note 10, at 1064.

³³ The name "copyright exhaustion" is common in foreign jurisdictions, while in the United States it is used interchangeably with "the first sale doctrine." See SHUBHA GHOSH, INT'L CTR. FOR TRADE & SUSTAINABLE DEV., THE IMPLEMENTATION OF EXHAUSTION POLICIES: LESSONS FROM NATIONAL EXPERIENCES 3 (2013), available at <http://www10.iadb.org/intal/intalcdi/PE/2014/13661.pdf>. The equivalent doctrines in other areas of intellectual property law are patent exhaustion and trademark exhaustion. *Id.*

³⁴ This right is subject to numerous exceptions. Many of them are discussed *infra* Part VI.

³⁵ *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351 (2013).

³⁶ See *Capitol Records, LLC v. ReDigi, Inc.*, 934 F. Supp. 2d 640 (S.D.N.Y. 2013); COPYRIGHT IN THE DIGITAL ECONOMY, *supra* note 3, at 35–37.

³⁷ See, e.g., *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010).

³⁸ See, e.g., Steven Seidenberg, *Market Mayhem: Sale of Gray Market Goods Heads to the Supreme Court*, INSIDE COUNS. (Feb. 1, 2010), <http://www.insidecounsel.com/2010/02/01/market-mayhem> ("In the IT sector alone, gray market goods accounted for \$58 billion in U.S. sales in 2007, costing the industry \$10

Comparative law suggests that there is no natural scope to the copyright exhaustion doctrine. Every legal system has rules regarding the exhaustion of copyright. In all legal systems some transactions trigger exhaustion, which in turn limits the scope of the exclusive rights of the copyright owner with respect to a copy of the work. However, the scope of the rules governing exhaustion substantially differ among legal systems. In particular, legal systems differ in answering two questions: first, what transactions trigger exhaustion, and second, in what way exhaustion narrows the scope of the exclusive rights.

While an authorized domestic sale of copyrighted goods typically triggers exhaustion, an authorized sale abroad might not. In countries that apply a regime called “national exhaustion,” such as India,³⁹ only a domestic sale triggers exhaustion. In those jurisdictions, the copyright owner’s permission is required to sell items that were first sold in another country. In other words, the copyright owner de facto receives an exclusive right over importation. In other countries, those that implement “international exhaustion,” which following the recent Supreme Court decision in *Kirtsaeng* also includes the United States,⁴⁰ a sale anywhere in the world triggers worldwide exhaustion with respect to the item sold. Finally, in other jurisdictions, those that implement “regional exhaustion,” exhaustion is triggered by an authorized sale within a certain region. For example, any sale of protected work in any part of the European Union triggers exhaustion within all other countries of the European Union.⁴¹ Thus, a copyright owner can limit the distribution in France of a book first sold in the United States but not of a book first sold in Germany.

billion in profits”); see also Brief of Amicus Curiae Costco Wholesale Corp. in Support of Petitioner at 1, *Kirtsaeng*, 133 S. Ct. 1351 (No. 11-697), 2012 WL 2832444 (“With annual sales of more than \$70 billion, Costco is known for selling genuine brand-name merchandise . . . at prices lower than its competitors. The first-sale doctrine [i.e., copyright exhaustion] plays an important role in Costco’s ability to do so.”).

³⁹ GHOSH, *supra* note 33, at 39–40. It should be noted that under Indian law rights in some kinds of copyrighted works, e.g. movie DVDs, are never exhausted. *Id.*

⁴⁰ *Kirtsaeng*, 133 S. Ct. 1351. Prior to this decision, the United States had an inconsistent mixed system of rules regarding exhaustion. While a sale of items manufactured domestically triggered exhaustion regardless of the place of sale (as is the case under an international exhaustion regime), see *Quality King Distribs., Inc. v. L’anza Research Int’l, Inc.*, 523 U.S. 135, 151 (1998), the law regarding items manufactured abroad was disputed. *Cf.* *John Wiley & Sons, Inc. v. Kirtsaeng*, 654 F.3d 210 (2d Cir. 2011) (finding that rights with respect to items manufactured abroad are never exhausted), *rev’d*, 133 S. Ct. 1351; *Denbicare U.S.A. Inc. v. Toys “R” Us, Inc.*, 84 F.3d 1143 (9th Cir. 1996) (concluding that only an authorized domestic sale of item manufactured abroad triggers exhaustion); *Sebastian Int’l, Inc. v. Consumer Contacts (PTY) Ltd.*, 847 F.2d 1093 (3d Cir. 1988) (holding that every authorized sale, domestic or not, of any copyrighted item triggers exhaustion).

⁴¹ GHOSH, *supra* note 33, at 36–37.

The effect of exhaustion once it is triggered also varies among jurisdictions. In the European Union, for example, even after exhaustion (i.e., after an authorized sale in the European Union), the holder of a copy of a copyrighted work (e.g., a book or a CD) is not allowed to rent it to others.⁴² However, countries in the European Union are allowed to permit public libraries to lend copies for free as long as the copyright holder is compensated.⁴³ In Israel, after exhaustion, commercial renting is prohibited, but noncommercial lending, including by public libraries, is allowed even without compensation of the author.⁴⁴ In the United States, after exhaustion (i.e., an authorized sale), the owner of a copy is allowed to rent and lend it for any purpose, for profit or not.⁴⁵

Indeed, there is no global consensus regarding the scope of copyright exhaustion. International Intellectual Property norms do not regulate exhaustion. The Berne Convention for the Protection of Literary and Artistic Works does not address the topic of exhaustion. The Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) goes a step further and explicitly states that “nothing in this Agreement shall be used to address the issue of the exhaustion of intellectual property rights.”⁴⁶

Therefore, comparative law does not shed light on the desirable scope of copyright exhaustion. This Article instead suggests that exploring the justifications for copyright exhaustion might provide better answers. That examination starts—with the historic rationales for the doctrine—in the next Part.

⁴² Rental Directive, *supra* note 22, art. 4, at 63.

⁴³ *Id.* art. 5, at 63–64.

⁴⁴ Copyright Act, 5768–2007, 2007 LSI 34, § 17 (Isr.), *translation available at* http://www.wipo.int/wipolex/en/text.jsp?file_id=255135 (World Intellectual Prop. Org., trans.). While in Israel compensation to the authors’ for public lending is not required by law, the state customarily provides it. Other countries have similar practices. *See generally* Charles A. Masango & Denise Rosemary Nicholson, *Public Lending Right: Prospects in South Africa’s Public Libraries?*, 74 S. AFR. J. LIBR. & INFO. SCI. 49 (2008), *available at* <http://sajlis.journals.ac.za/pub/article/view/1257/1404> (examining the ways in which different countries compensate authors for the public lending of their work).

⁴⁵ 17 U.S.C. § 109(a) (2012). However, the owners of phonorecords (e.g., music CDs) and software are not permitted to rent or lend those goods for profit. *Id.* § 109(b).

⁴⁶ Agreement on Trade-Related Aspects of Intellectual Property Rights, art. 6, Apr. 15, 1994, 108 Stat. 4809, 1869 U.N.T.S. 299.

II. HISTORIC JUSTIFICATIONS FOR COPYRIGHT EXHAUSTION

What are the justifications for copyright exhaustion? Why shouldn't the copyright owner control the distribution of copyrighted works? This Part explores whether the historic theoretical pillars that contributed to the creation of the doctrine a century ago can justify and help shape its scope nowadays. It concludes they cannot.

Copyright exhaustion originated in the Supreme Court decision in *Bobbs-Merrill Co. v. Straus*.⁴⁷ In that case, the plaintiff, Bobbs-Merrill Co., included a notice in a copyrighted book stating it was not to be sold for less than \$1. The defendant, R.H. Macy & Company (now commonly known as Macy's), sold the book for eighty-nine cents and was sued for copyright infringement.⁴⁸ The Supreme Court held that the copyright owner's exclusive right to "vend" copies in which the work is embodied extends to the first sale of those copies but not to a future resale.⁴⁹ The first sale thus exhausts the copyright owner's distribution rights. For that reason, Bobbs-Merrill could not have controlled the resale of the book by R.H. Macy & Company.

A year later, this principle was codified in the Copyright Act of 1909.⁵⁰ A similar provision (although not an identical one) was later included in the Copyright Act of 1976.⁵¹

While *Bobbs-Merrill* is a statutory interpretation case,⁵² the decision cannot be fully understood without appreciating several general legal principles that

⁴⁷ 210 U.S. 339 (1908).

⁴⁸ *Id.* at 341–42.

⁴⁹ *Id.* at 350–51.

⁵⁰ ch. 320, § 41, 35 Stat. 1075, 1084 (later codified as 17 U.S.C. § 41 (1926)) (“[N]othing in this title shall be deemed to forbid, prevent, or restrict the transfer of any copy of a copyrighted work the possession of which has been lawfully obtained.”) (repealed 1976).

⁵¹ Pub. L. 94-553, § 109(a), 90 Stat. 2541, 2548 (codified as amended as 17 U.S.C. § 109(a) (2012)) (“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.”). While many perceive Section 41 of the 1909 Act and Section 109 of the 1976 Act as the codification of the *Bobbs-Merrill* precedent and the principles of copyright exhaustion, some have argued that the doctrine is broader than the statutory language, and therefore exhaustion can be found even when a transaction falls outside the scope of Section 109. *See, e.g.*, Brief for the United States as Amicus Curiae Supporting Respondent at 27–29, *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351 (2013) (No. 11-697), 2012 WL 3902599; Perzanowski & Schultz, *supra* note 7, at 2113–15.

⁵² Specifically, the Court in *Bobbs-Merrill* interpreted Section 4952 of the Revised Statutes of the United States, which read “Any . . . author . . . of any book . . . and the . . . assigns of any such person, shall . . . have

dominated the discussion on exhaustion of intellectual property early in the twentieth century.⁵³ These principles include the extreme hostility to vertical restraints along the chain of distribution and the common law rule that prohibited servitudes on chattels and restraints on alienation. This Part explores these theoretical pillars. It suggests that a century ago these principles were broadly accepted and strictly applied, which can explain why the rules of exhaustion were similarly strict. However, nowadays these principles are more controversial and their application is subject to flexible legal standards. Therefore, the strict rules of copyright exhaustion can no longer be supported by these principles. This Part therefore suggests that, to paraphrase Maitland,⁵⁴ unfortunately, these theoretical historic justifications we have buried still rule us from their graves.

A. Regulating Vertical Restraint: From Strict Per Se Prohibition to a Narrow and Flexible Rule of Reason Test

The *Bobbs-Merrill* decision and the emergence of copyright exhaustion cannot be entirely understood without appreciating the extreme hostility to vertical restraints that was common at the time.⁵⁵ The plaintiff in *Bobbs-Merrill* tried to exercise control along the distribution chain by implementing a minimum resale price maintenance (RPM) scheme,⁵⁶ which at the time was considered anticompetitive and per se illegal under antitrust

the sole liberty of . . . vending the same.” See 210 U.S. at 348 (quoting U.S. Comp. St. § 4952 (1901) (repealed 1909)).

⁵³ Patent exhaustion emerged several decades before copyright exhaustion in *Adams v. Burke*, 84 U.S. (17 Wall.) 453 (1873). The two doctrines, while not identical, rely to some extent on similar theoretical principles, which are presented in this Part of the Article.

⁵⁴ F. W. MAITLAND, *Lecture I: The Forms of Action at Common Law*, in *EQUITY ALSO THE FORMS OF ACTION AT COMMON LAW* 295, 296 (A. H. Chaytor & W. J. Whittaker eds., 1910) (“The forms of action we have buried, but they still rule us from their graves.”).

⁵⁵ Hovenkamp, *supra* note 9, at 504 (“Over history, most of the Supreme Court’s decisions on the first sale doctrine have attached its rationale to competition policy.”); Ariel Katz, *The First Sale Doctrine and the Economics of Post-Sale Restraints*, 2014 *BYU L. REV.* 55, 65–66 (“[T]he first sale doctrine and antitrust law’s treatment of vertical restraints are nothing but two sides of the same coin.”); Perzanowski & Schultz, *supra* note 7, at 2113; Robinson, *supra* note 5, at 1453–54 (“[T]he first sale doctrine first arose in the context of resale price restraints—an antitrust offense of long standing.”). For a detailed discussion on the hostility to vertical restraints and its effect on the exhaustion of intellectual property rights, see Hovenkamp, *supra* note 9, at 503–10. The discussion in this section relies on Professor Hovenkamp’s article.

⁵⁶ Resale price maintenance (RPM) refers to various practices that are designed to keep a certain limitation on the price of a product along the chain of commerce. See Hovenkamp, *supra* note 9, at 488. The most common version of RPM, sometimes called minimum resale price scheme, attempts, as its name suggests, to place a mandatory minimum retail price (a floor) for a certain product.

law.⁵⁷ In fact, many post-sale restrictions on alienation, which are typically inconsistent with the principles of copyright exhaustion, can be described as an attempt to enforce vertical restraints.⁵⁸ In the first decades of the twentieth century, most of those arrangements were considered per se illegal under antitrust law.⁵⁹

This patent hostility can be explained by the perception that those arrangements are typically, if not always, designed to limit competition along the distribution chain. Thus, when Bobbs-Merrill set a minimum price of \$1 for its books, it limited competition among retailers. If, for example, it sold the books to retailers for eighty cents, then it would allegedly be anticompetitive to prevent those retailers to compete with one another and offer the book for less than \$1. In addition, many were concerned that some vertical restraints allowed monopoly pricing along the chain of distribution, and so the monopolist copyright owner can allegedly extend its monopoly power from one market to another, currently competitive, market.⁶⁰

Modern economics, and in particular the economists of the Chicago school of economics, showed that those concerns are oversimplified and in many cases overstated or wrong.⁶¹ First, vertical restraints, including tying

⁵⁷ *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373, 408 (1911) (holding RPM schemes are per se unlawful under antitrust laws), *overruled by* *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007) (applying a rule of reason); *see also* Hovenkamp, *supra* note 9, at 504–10.

⁵⁸ Vertical restraints are limitations that are placed along different parts of the chain of manufacturing and distributing a product. *See* Hovenkamp, *supra* note 9, at 488–89. For example, in *Kirtsaeng*, the publisher was trying to create a geographic exclusivity arrangement—a form of a vertical restraint, which can guarantee that books that are initially sold abroad remain in their original distribution chain. *See* *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1356 (2013). Adobe, in *SoftMan Products Co. v. Adobe Systems Inc.*, 171 F. Supp. 2d 1075 (C.D. Cal. 2001), tried to enforce another type of a vertical restraint, called a tying arrangement, *see infra* note 62, in which two (or more) products are always sold together along the chain of distribution.

⁵⁹ *See, e.g.*, Clayton Act, ch. 323 § 3, 38 Stat. 730, 731 (1914) (current version codified at 15 U.S.C. § 14 (2012)) (tying arrangements illegal); *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502 (1917) (tying arrangements are unenforceable as a matter of patent law, which is supported by antitrust concerns, as expressed by the Clayton Act); *supra* note 57.

⁶⁰ *See* ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 372–75 (1978).

⁶¹ *See, e.g.*, BORK, *supra* note 60, at 373–81; Richard A. Posner, *The Chicago School of Antitrust Analysis*, 127 U. PA. L. REV. 925 (1979); Robinson, *supra* note 5, at 1501–02.

arrangements,⁶² usually do not allow a monopolist⁶³ to earn more than a single monopoly premium along the distribution chain, and it typically cannot extend its monopoly power to related competitive markets. Thus, for example, if a company has a monopoly in the market for printers but the market for ink cartridges is competitive,⁶⁴ it cannot increase its total profits by tying the printer and the ink cartridges (i.e., forcing buyers to buy its own cartridges) or by setting a minimum price in the ink market. The consumers' purchasing decisions are determined by the combined price of the printer and the cartridges, and, therefore, no matter what vertical restraints are implemented, the monopolist can extract one monopoly rent on this combination as a whole. Even if the products are tied, it can do so by, *inter alia*, charging a monopoly price for the printer and a competitive price on cartridges, or vice versa, but the monopolist will not charge a full monopoly rent in both markets because it will raise prices for the consumer and will reduce quantities to a level that is undesirable for the monopolist.⁶⁵

Second, vertical restraints can sometime have pro-competition effects. They, among other things, encourage interbrand competition instead of intrabrand competition and thus they can eliminate free riding.⁶⁶ Mandatory

⁶² A tying arrangement is the practice of selling one product (or service) as a mandatory condition of selling another product (or service). *See, e.g.,* Hovenkamp, *supra* note 9, at 488. Interpreted broadly, tying arrangements are very common. Law schools, for example, condition the service of teaching first-year Contracts on the teaching of first-year Torts. Of course, antitrust law defines tying arrangements more narrowly. *See, e.g.,* Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 19 (1984). Several well-known copyright exhaustion cases can be thought of as analyzing tying arrangements. *See supra* note 58. A full analysis of the efficiency (or lack thereof) and legality (or lack thereof) of tying arrangements is well beyond the scope of this Article.

⁶³ The term monopolist, as used here, refers to an economic actor with significant market power, not necessarily an actor who is the sole seller in a given market or a company that will be considered a monopolist under antitrust law.

⁶⁴ This example is loosely based on the facts of *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28, 31–33 (2006).

⁶⁵ There are of course exceptions to this rule. For example, if there are high barriers to entry in the competitive market, the seller can cross subsidize its products in the competitive market, sell them below costs, and drive its competitors out of the market. This can be desirable to the monopolist if, for example, it can help deter entrance to related markets. Thus, for example, if the monopolist producer of printers can drive competitors out of the market for ink cartridges, and if barriers to entry are high for that market, this can help it solidify its monopoly position in the market for printers. *See also* Louis Kaplow, *Extension of Monopoly Power Through Leverage*, 85 COLUM. L. REV. 515, 520–39 (1985) (exploring situations in which a monopoly position can allow a monopolist to extend its monopoly power).

⁶⁶ Hovenkamp, *supra* note 9, at 490. Interbrand competition is competition between sellers of different brands. *See id.* at 488–89. Intrabrand competition is a competition between the sellers of the same brand. *See id.* at 488. Thus, as explained below, tying arrangement can encourage competition between brands (e.g., Toyota versus Honda) while possibly discouraging competition within a brand (e.g., between two near Toyota dealerships).

minimum prices, for example, can facilitate non-price competition and thus incentivize retailers to offer additional point-of-sale services. Without them, retailers who do not provide those services might free-ride those who do provide them. For example, online retailers might free-ride on brick and mortar retailers who provide expensive showroom services to buyers. This will create a disincentive to provide the point-of-sale service, which might harm the market share of the product. The manufacturer can tackle this difficulty by enforcing a minimum retail price along the chain of distribution. This of course might be inconsistent with the principles of copyright exhaustion, which, as demonstrated in *Bobbs-Merrill*, makes the enforcement of those arrangements difficult.

For those reasons, antitrust law moved away from the per se prohibition on vertical restraints, overruling many of the precedents in this area, and instead applies a rule of reason test.⁶⁷ Indeed, instead of holding all vertical restraints illegal, the modern rule of reason test requires the fact-finder to weigh all of the circumstances of a case in deciding whether a practice should be prohibited as imposing an unreasonable restraint on competition and whether that practice has an anticompetitive or procompetitive effect.⁶⁸

This progress creates a tension between antitrust law and intellectual property law. While antitrust law permits many vertical restraints, as they can promote, or at least not harm competition, the exhaustion rules of intellectual property law might make their enforcement difficult. Indeed, while some modern commentators attribute pro-competitive rationales to copyright exhaustion,⁶⁹ the inflexible nature of that doctrine seems inconsistent with our sophisticated modern understanding of the economic forces at play in vertical restraints arrangements.

It is important to note that some vertical restraints do raise competitive concerns, especially when they facilitate horizontal restraints (i.e., between

⁶⁷ See, e.g., *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007) (applying the rule of reason to resale minimum price arrangement); *State Oil Co. v. Khan*, 522 U.S. 3 (1997) (applying the rule of reason to vertical determination of a maximum resale price); *Cont'l T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977) (applying the rule of reason to non-price vertical restraints); *Case C-279/06 CEPSA Estaciones de Servicio SA v LV Tobar e Hijos SL*, 2008 E.C.R. I-6681 (applying the rule of reason to vertical restraints under European Union law).

⁶⁸ *Leegin*, 533 U.S. at 885–86.

⁶⁹ See *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1363 (2013) (discussing the need to promote competition as a justification for copyright exhaustion); Reese, *supra* note 9, at 585 (discussing the ways in which copyright exhaustion fosters competition).

direct competitors), which are anticompetitive.⁷⁰ For example, a cartel among manufacturers that is designed to keep prices artificially high can be unstable because of the difficulty to observe the price that cartel members charge their distributors. A minimum RPM scheme can assist the cartel because the prices charged to consumers are easy to monitor.⁷¹ Similarly, a cartel among retailers can be enforced by the manufacturer (at the cartel's demand) using a minimum RPM scheme. This can make entry to the retail market difficult and discourage innovations along the distribution chain.⁷²

Therefore, promoting competition can sometimes justify limitations on vertical restraints (with respect to items protected by intellectual property rights and those that are not) but in other cases, which might be more common, they cannot.⁷³ Antitrust law can handle those situations in which vertical restraints harm competition better than copyright exhaustion.⁷⁴ By restraining many types of vertical restraints, anticompetitive (such as those in

⁷⁰ *Leegin*, 551 U.S. at 892–94.

⁷¹ This is in fact the exact scheme that motivated the minimum RPM scheme in *Bobbs-Merrill*. Katz, *supra* note 55, at 67–68. This, of course, seems to be a clear violation of antitrust law, as existed then and as exists now. However, in *Bobbs-Merrill*, because the Supreme Court held that the manufacturer cannot enforce its RPM scheme under copyright law, it did not see a need to discuss the alleged violation of antitrust law. *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339, 351 (1908).

⁷² *Leegin*, 551 U.S. at 893–94. Similar conditions can emerge even without a cartel. For example, if a distributor has a significant market power, it can force vertical restraints on manufacturers and limit their transaction with competitors and thus eliminate competition. See *Toys “R” Us, Inc. v. FTC*, 221 F.3d 928 (7th Cir. 2000).

⁷³ Hovenkamp, *supra* note 9, at 492 (“[T]hese reasons [for limiting vertical restraints because of antitrust concerns] do not exist in every case, or even the majority of them.”); cf. *Leegin*, 551 U.S. at 915–16 (Breyer, J., dissenting) (arguing that it is unclear how often vertical price maintenance arrangements are pro-competitive).

The decrease in the barriers to entry in many copyright industries might make it less likely that vertical restraints would be anticompetitive. See Guy A. Rub, *Stronger than Kryptonite? Inalienable Profit-Sharing Schemes in Copyright Law*, 27 HARV. J.L. & TECH. 49, 128–29 (2013); Molly Shaffer Van Houweling, *Author Autonomy and Atomism in Copyright Law*, 96 VA. L. REV. 549, 615 (2010); Joel Waldfogel, *And the Bands Played On: Digital Disintermediation and the Quality of New Recorded Music* (June 25, 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=2117372>.

However, even the reduction in the barrier to entry cannot completely eliminate antitrust concerns in copyright related industries. For example, the Department of Justice recently claimed that a few large book publishers were engaged in limited collusion, possibly in concert with Apple. See Final Form Joint Brief for Plaintiffs-Appellees United States and Plaintiff-States at 4, *United States v. Apple Inc.*, No. 13-3741 (2d Cir. July 15, 2014), available at <http://www.justice.gov/atr/cases/f306100/306194.pdf>; see also U.S. DEP’T OF JUSTICE, ANTITRUST CASE FILINGS, UNITED STATES V. APPLE, INC. (2013), available at <http://www.justice.gov/atr/cases/applebooks.html>.

⁷⁴ See Robinson, *supra* note 5, at 1453 (“[A]ntitrust policy provides a completely sufficient grounds for withholding legal enforcement of the restrictions [on alienation] and makes it separately actionable.”).

Bobbs-Merrill) or not (such as those in *Kirtsaeng*),⁷⁵ copyright exhaustion seems too rigid and significantly over-inclusive, and it can thus undermine the pro-competitive goals of antitrust policy. Indeed, it tries to kill a fly with a sledgehammer, and it sometimes misses. In contrast, antitrust law (as well as antitrust lawyers and the Federal Trade Commission) is equipped with tools to handle such complex situations, primarily through its flexible rule-of-reason jurisprudence.⁷⁶

The conclusion is that it is doubtful if the copyright exhaustion doctrine is a desirable tool to promote competition. However, even if it can promote competition, in its current strict form, it is unlikely to be able to do so. The inflexibility of copyright exhaustion was suitable in the era of the per se prohibition on vertical restraints but as we have abandoned this approach in antitrust law, the continued strict enforcement of the rules of exhaustion cannot be justified by pro-competition policy.

B. Restraints on Alienation of Property and Servitudes on Chattel: From a Broad Prohibition to a Limited Reasonableness Test

Common law refused to enforce most restraints on alienation of property and it did not recognize servitudes on chattel. Both prohibitions, but especially the hostility to restraints on alienation, inspired the emergence of copyright exhaustion, and they fuel its discourse to this day. The Supreme Court recently stated that “[t]he ‘first sale’ doctrine is a common-law doctrine with an impeccable historic pedigree.”⁷⁷ The Court went on to explain how Lord Coke, in the early seventeenth century, relying on a fifteenth-century opinion of Lord Littleton, had held that enforcing such limitations is “against Trade and Traffi[c], and bargaining and contracting” and concluded 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.’”⁷⁸

⁷⁵ As further discussed in *infra* Part III, the plaintiff-sellers in *Kirtsaeng* tried to implement a geographic segmentation scheme, which typically does not raise antitrust concerns. Indeed, the parties to *Kirtsaeng* did not raise such arguments.

⁷⁶ See also Robinson, *supra* note 5, at 1503–04 (calling for a flexible regulations through antitrust law of vertical restraints that do not go beyond what is justified by specific public policy).

⁷⁷ *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1363 (2013).

⁷⁸ *Id.* (alterations in original) (quoting EDW. COKE, THE FIRST PART OF THE INSTITUTES OF THE LAWS OF ENGLAND § 360, at 223 (London, Adam Islip 1628)).

Relying on either Lord Littleton's or Lord Coke's reasoning or on the common law rule to justify copyright exhaustion in the twenty-first century is problematic. Both Littleton and Coke held that enforcing restraints on alienation is "repugnant to the nature of a fee," which means that it is inconsistent with the technical nature of the common law estate.⁷⁹ There are at least two main obstacles in applying this reasoning to copyrighted goods. First, if the nature of the property interest in question in those old common law authorities did not permit restraints on alienation, it should not automatically lead us to conclude that the property interest at question in *Kirtsaeng*, which is quite different in nature, incorporates the same technical limitation. Second, and more importantly, relying on the technical argument regarding the repugnancy to the nature of a fee is problematic in itself and was heavily criticized by later commentators. For example, Professor John Chipman Gray, who in 1883 published the leading treatise on restraints on alienation, "contended that forbidding restraints in our modern law would be unjustified if repugnancy were the only reason."⁸⁰ Similarly, in 1935 Professor Richard Manning wrote that "continued use of the argument of repugnancy as a short cut to a desired result or to conceal a rule not founded on public interest is, to say the least, lamentable."⁸¹ Most modern commentators agree.⁸²

This last point requires elaboration. Both Gray and Manning supported prohibiting most restraints on alienation, but their justifications were based on the economic realities and the context in which those limitations on alienation were placed. Historically, the prohibition on restraints on alienation emerged in the thirteenth century as a way to deal with the land structure in feudal England.⁸³ Centuries later, in the nineteenth century, Gray was truly concerned with the phenomenon of spendthrift trusts, in which restraints on alienations limit the creditors' ability to reach the corpus of the trust.⁸⁴ Gray saw it as a

⁷⁹ Richard E. Manning, *The Development of Restraints on Alienation Since Gray*, 48 HARV. L. REV. 373, 401 (1935).

⁸⁰ Manning, *supra* note 79, at 402 (citing JOHN CHIPMAN GRAY, RESTRAINTS ON THE ALIENATION OF PROPERTY § 21 (Boston, Boston Book Co., 2d ed. 1895)).

⁸¹ *Id.* at 402–03.

⁸² See, e.g., Epstein, *supra* note 5, at 465–68; Robinson, *supra* note 5, at 1453, 1481 (suggesting that relying on the common law prohibition on restraints of alienation nowadays is "flimsy"); see also Zechariah Chafee, Jr., *Equitable Servitudes on Chattels*, 41 HARV. L. REV. 945 (1928) (suggesting similarly that not enforcing servitudes on chattel is unjustified).

⁸³ Robinson, *supra* note 5, at 1480.

⁸⁴ Spendthrift trusts allow the grantor to limit the transferability of the corpus of the trust, including to creditors of the beneficiaries of the trust. See RESTATEMENT (THIRD) OF TRUSTS § 58 (2003); Karen E. Boxx, *Gray's Ghost—A Conversation About the Onshore Trust*, 85 IOWA L. REV. 1195 (2000) (exploring Gray's opposition to spendthrift trusts); Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*,

misguided paternalistic policy that is inconsistent with the Anglo-Saxon traditions of individualism and a step toward socialism.⁸⁵ Whether we agree with Gray's criticism of spendthrift trusts or not is beside the point. The point is that the hostility toward restraints on alienation was—and should still be—supported by sound public policy that was motivated by the economic realities of the time. It is far from being self-evident that the economic realities of our time support a similar hostility. Those who are quick to rely on this historic hostility do not provide such evidence. It is doubtful it exists. Clearly, the concerns about creditors' rights that motivated Gray and Manning have nothing to do with copyright exhaustion. Most of the other rationales that Gray, Manning, and other scholars and judges raised to justify the prohibition on restraints on alienation—e.g., a desire to hold people accountable for their debts, to allow improvement of property, or to fight racial discrimination⁸⁶—are similarly inapplicable to copyright policy.

In fact, property law itself abandoned its strict resentment toward restrictions on alienation. Nowadays, in most jurisdictions, the common law's strict approach has been rejected even with respect to real property. Instead, restraints on alienation are subject to a general reasonableness test to determine whether they are enforceable.⁸⁷ In some cases, which might not be common, courts also seem willing to enforce some servitudes on chattels.⁸⁸ These modern developments in property law suggest that the automatic broad refusal in common law to enforce restraints on alienation is no longer warranted.

Thus, the continued reliance in copyright discourse on the obsolete principles of the common law seems inadequate. In some cases, hostility to restraints on alienation can be supported by economic arguments, but those arguments must be articulated and evaluated. As the modern developments in real property law suggest, once the economic arguments are no longer convincing, the law should no longer strictly refuse to enforce those restrictions. Arguments regarding the “repugnancy to the nature of a fee” no longer carry the day in real property discourse. Relying on authorities that embraced this ancient reasoning is thus unfortunate. Indeed, contrary to the

85 CORNELL L. REV. 1035, 1043 (2000) (explaining that although spendthrift trusts used to be controversial they have “become an entrenched feature of American trust law”).

⁸⁵ Manning, *supra* note 79, at 403–04.

⁸⁶ *Id.*

⁸⁷ Singer, *supra* note 14.

⁸⁸ Robinson, *supra* note 5, at 1456–58 (exploring twentieth-century cases in which courts enforced servitudes on chattel, including servitudes that facilitated price discrimination).

recent assertion of the Supreme Court,⁸⁹ the “historic pedigree” of copyright exhaustion is quite short of being “impeccable.”

Almost eighty years ago, Professor Manning cautioned that the enforceability of restraints on alienation “is peculiarly responsive to changing conditions and times”⁹⁰ and that courts should rely on “a more cogent line of reasoning than those depending upon the metaphysics of repugnancy.”⁹¹ The next Parts of this Article answer this call by exploring whether, and to what extent, the prohibitions on restraints on alienation, as facilitated by copyright exhaustion, are supported by the economics of copyright related markets.

III. THE COST OF COPYRIGHT EXHAUSTION: THE EFFECTS ON THE INCENTIVES–ACCESS TRADEOFF

The previous Part suggests that the legal principles that inspired the emergence of the copyright exhaustion doctrine cannot justify it today. Therefore, these principles can provide very limited assistance in determining the scope of the doctrine. This Part, together with Part IV and Part V, examines additional possible rationales for copyright exhaustion.

This Part focuses on copyright exhaustion’s effect on the balance between incentives to create and public access to information goods. It suggests that because copyright-exhaustion doctrine restricts the copyright owner’s ability to engage in a certain pricing scheme—collectively called price discrimination—the application of the doctrine typically has an undesirable effects on social welfare.

Section A explains how a sound copyright policy aims to promote both authors’ incentives to create works and public access to the works created. Section B introduces price discrimination as a common pricing scheme that is employed by many copyright owners. Section C explains how copyright exhaustion restricts the copyright owners’ ability to engage in certain kinds of price-discrimination schemes. Then, the most important section in this Part, section D, explores the welfare effects of those limitations. It concludes that copyright exhaustion typically reduces the incentives to create and has only a modest effect on access to copyrighted work.

⁸⁹ *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1363 (2013) (“[T]he ‘first sale’ doctrine is a common-law doctrine with an impeccable historic pedigree.”).

⁹⁰ Manning, *supra* note 79, at 373.

⁹¹ *Id.* at 404.

One important note is in order. In this Part, Part III, as well as in the next Part, Part IV, it is assumed that there are negligible information costs in the market for copyrighted goods. The reason for making this assumption is purely methodological. Parts III and IV explore whether copyright exhaustion can be justified *without* relying on its socially desirable effect on information costs. They conclude that it cannot. That conclusion will play a crucial role in later Parts of this Article. In Part V, the assumption regarding negligible information costs is relaxed, which will allow the reader to fully appreciate the significance of copyright exhaustion in reducing information costs.

A. *On the Incentives–Access Tradeoff*

A sound copyright policy must incentivize the creation and distribution of creative works and to provide wide access to those works.⁹² However, those two goals typically conflict with one another and therefore the promotion of one needs to be balanced against the promotion of the other. This is the famous incentives–access tradeoff. This section briefly presents the problem of promoting incentives and access. Later sections explore how copyright exhaustion affects this balance.

The first goal of copyright law, and in many respects its *raison d’être*, is to provide incentives to create.⁹³ The production of information goods is typically socially desirable, partly because they are non-rivalrous, i.e., the consumption by one buyer does not harm the consumption of another. Thus, when Charlie listens to a song on the radio, Dan can listen to the same song at the same time without bothering Charlie. Therefore, the production of one information good can benefit many. Unfortunately, without legal intervention, information goods can typically be copied easily, which will give uncontrolled access to nonpayers and will deny income to the creator. Competition can drive prices down close to the marginal cost of production, which will prevent the author

⁹² This is of course not a complete list of all the goals of copyright law. Additional goals include, among other things, protecting the authors’ personhood and labor interest in the work, promoting other social goals such as a robust market of ideas, and more.

⁹³ See, e.g., *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 429 (1984) (noting that copyright is “intended to motivate the creative activity of authors . . . by the provision of a special reward”); *Mazer v. Stein*, 347 U.S. 201, 219 (1954) (“The economic philosophy behind the clause empowering Congress to grant patents and copyrights is the conviction that encouragement of individual effort by personal gain is the best way to advance public welfare . . .”).

from recouping the cost of creation⁹⁴ and will discourage the author from producing information goods.

Legal intervention might therefore be required.⁹⁵ Intellectual property law remedies this problem by allowing the producer of information goods to exclude some nonpayers. The provider of information goods thus faces just limited competition and can charge a price that is above the marginal cost of production and thus covers the fixed costs of creation. This is the assent of the incentive theory, which is at the core of intellectual property law in the United States.⁹⁶

While copyright law provides incentives to create, it also restricts public access to information goods by limiting competition and granting the copyright owner some market power.⁹⁷ When market power allows the seller to price goods for more than their marginal cost of production, some buyers—those that are willing to pay more than the marginal cost of production but less than the monopoly price—are priced out of the market.⁹⁸ In this way, the law limits access to the work. This is inefficient. From a social perspective, a transaction in which a seller transfers a good to a voluntary buyer for a price that is above the marginal cost of production is beneficial to all parties and therefore to society at large. By fostering higher prices, copyright law denies society the potential surplus from those lost transactions. This loss of surplus is called a deadweight loss, and it is a common socially undesirable side effect of intellectual property law.

⁹⁴ Because the fixed costs of creating information goods are high and the marginal costs are very low, the average cost is typically higher than the marginal cost. As a result, if competition drives prices toward marginal costs, the total cost of production (the average cost multiplied by the number of copies sold) cannot be recovered.

⁹⁵ Cf. WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF INTELLECTUAL PROPERTY LAW* 41–49 (2003) (showing that in some cases creators can recover the fixed cost of creation without relying on intellectual property rights, while in other cases they cannot).

⁹⁶ Other legal systems, in particular civil law jurisdictions, justify copyright law on other grounds and, in particular, on the author's natural rights. See generally Jane C. Ginsburg, *A Tale of Two Copyrights: Literary Property in Revolutionary France and America*, 64 *TUL. L. REV.* 991 (1990) (exploring the different justifications for copyright law under French and United States law).

⁹⁷ See, e.g., *Sony*, 464 U.S. at 480 (Blackmun, J., dissenting) (“Copyright gives the author a right to limit or even to cut off access to his work.”); Stephen Breyer, *The Uneasy Case for Copyright: A Study of Copyright in Books, Photocopies, and Computer Programs*, 84 *HARV. L. REV.* 281, 313 (1970) (“Removing copyright protection should induce competition in the production and sale of relatively high-volume titles. Readers of these books should benefit from lower prices.”); Jeanne C. Fromer, *Expressive Incentives in Intellectual Property*, 98 *VA. L. REV.* 1745, 1752 (2012) (“[E]xclusive rights in intellectual property can prevent competition in protected works, thereby allowing the rightsholder to charge a premium for access and ultimately limiting these valuable works’ diffusion to society at large.”).

⁹⁸ Rub, *supra* note 17, at 261.

Unfortunately, there is an inherent and frequent conflict between providing incentives and broadening access. This conflict is commonly referred to as the “incentives–access tradeoff.”⁹⁹ Most legal norms that increase the incentives to create also reduce access to the work and vice versa.¹⁰⁰ However, norms differ in the magnitude of those effects.¹⁰¹ Therefore, copyright law should consist of norms that provide authors with significant incentives¹⁰² with little reduction to access as well as norms that provide significant access with little harm to incentives.

With these criteria in mind, the effects and desirability of copyright exhaustion can be evaluated. It will be shown that this doctrine typically reduces incentives to create without increasing public access to copyrighted works and thus, under these criteria, it is undesirable. The reduction in incentives stems from the limitation that copyright exhaustion places on price discrimination, to which this Article now turns.

⁹⁹ See, e.g., *Stewart v. Abend*, 495 U.S. 207, 228 (1990) (“[T]he [Copyright] Act creates a balance between the artist’s right to control the work during the term of the copyright protection and the public’s need for access to creative works.”); Julie E. Cohen, *Copyright and the Perfect Curve*, 53 VAND. L. REV. 1799, 1801–03 (2000).

¹⁰⁰ For example, expanding the copyright owner’s exclusive rights to include derivative works gives authors an additional source of income and thus improves the incentives to create. However, at the same time, this expansion raises the cost of creating derivative products (e.g., translations) and thus reduces the access to those works. Similarly, the fair use defense provides that some usages (e.g., parody) do not require a license and are therefore cheaper, which improves access to the work, but at the same time it denies authors a source of income and thus reduces the incentives to create.

¹⁰¹ See Louis Kaplow, *The Patent-Antitrust Intersection: A Reappraisal*, 97 HARV. L. REV. 1813, 1821 (1984) (noting in the context of patents that “[i]t is simply not true that all activities generating equal profits impose equal damages upon society”); Rub, *supra* note 17, at 279.

¹⁰² It is possible to provide too much incentive to create. See Michael Abramowicz, *An Industrial Organization Approach to Copyright Law*, 46 WM. & MARY L. REV. 33, 71–77 (2004) (suggesting that according to certain models of imperfect competition over-incentivizing can lead to excessive entry into a given market, which wastes resources); Christopher S. Yoo, *Copyright and Product Differentiation*, 79 N.Y.U. L. REV. 212, 260–64 (2004) (same); see also Glynn S. Lunney, Jr., *Copyright’s Price Discrimination Panacea*, 21 HARV. J.L. & TECH. 387 (2008) (suggesting that over-incentivizing can channel valuable social resources to inefficient creative activities). It is difficult to know if the current incentives to create have reached that point and this Article does not settle this question. Nevertheless, the analysis in this Part implies that if the incentives are too high, reducing them by restricting price discrimination is, all else being equal, undesirable. Other incentive-enhancing mechanisms that are part of our copyright law regime are significantly more harmful as they significantly harm access and spillovers. Therefore, if reduction in incentives is desirable, these other mechanisms should be restricted first. See Rub, *supra* note 17, at 275–76 (explaining how a regime that broadens price discrimination and shortens copyright duration is superior to a regime that prohibits price discrimination and extends copyright duration).

B. *Price Discrimination in the Market for Copyrighted Goods*

Defining the term “price discrimination” is not a trivial task. As a leading economic treatise puts it, “[r]oughly, it can be said that the producer price-discriminates when two units of the same. . . good are sold at different prices. . . . This definition is unsatisfactory.”¹⁰³ This section explains how copyright owners can employ price-discrimination schemes to deal with variation in demand among their buyers.¹⁰⁴ The next section will explain how Copyright Exhaustion interferes with such pricing schemes.

Sellers with market power¹⁰⁵ choose prices for their products that will maximize their total revenues. Price-discrimination schemes allow those sellers to deal with buyers who vary in their willingness to pay. Economic literature separates those schemes into three categories.¹⁰⁶ With first-degree price discrimination the seller charges each buyer a price equal to that buyer’s willingness to pay. This scheme allows the producer to increase quantities and sell the product to each buyer who is willing to pay more than the marginal cost of production. Thus, the deadweight loss, which is a common side effect of monopoly power,¹⁰⁷ is eliminated. Unfortunately, perfect price discrimination can rarely be achieved because the buyers’ reservation price is private information that sellers do not know.¹⁰⁸

Therefore, sellers have developed pricing schemes that allow them to indirectly assess those reservation prices. Both second- and third-degree price-discrimination schemes use an approximation method to sort the consumers into subgroups and match a different price to each subgroup. Second- and third-degree price-discrimination schemes differ in the ways in which this sorting and estimation is done.

¹⁰³ JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 133 (1988).

¹⁰⁴ Price discrimination in information goods was subject to extensive discussion in copyright literature in recent years. *See, e.g.*, Cohen, *supra* note 99; Fisher, *supra* note 17; Lunney, *supra* note 102; Michael J. Meurer, *Copyright Law and Price Discrimination*, 23 *CARDOZO L. REV.* 55 (2001); Randal C. Picker, *Easterbrook on Copyright*, 77 *U. CHI. L. REV.* 1165 (2010); Picker, *supra* note 17; Rub, *supra* note 17; Yoo, *supra* note 102.

¹⁰⁵ A seller who has no market power is a price taker and thus cannot make pricing decisions. However, because intellectual property rights restrict competition, one may assume that owners of those rights have some market power.

¹⁰⁶ *See, e.g.*, TIROLE, *supra* note 103, at 135; Rub, *supra* note 17, at 261–63.

¹⁰⁷ *See supra* Part III.A.

¹⁰⁸ *See* Rub, *supra* note 17, at 262.

Simply put, a second-degree price-discrimination scheme, also called versioning, means that the seller offers slightly different versions of its product for different prices to all consumers.¹⁰⁹ The variations between the versions, such as differences in quality or quantity, are evaluated differently by different consumers and constitute a tool of self-selection that helps the seller to identify those with higher willingness to pay and lower elasticity of demand.¹¹⁰ As an example, consider the choice between Windows 8 and Windows 8 Pro or between a hardcover book and a paperback. In both cases, the differences in the cost of producing the different versions are small but the differences in prices are significant. In those cases, the high-price, high-quality products target those consumers with high willingness to pay and low elasticity of demand. Those buyers do not mind paying significantly more to receive a slightly better product.

When sellers implement a third-degree price-discrimination scheme, they offer the same product to different subgroups of consumers for different prices.¹¹¹ The sellers use some exogenous known information about their consumers (e.g., their age, occupation, location, etc.) to estimate the consumers' reservation prices. For example, movie tickets are cheaper for senior citizens and textbooks are cheaper for buyers in developing countries because, on average, senior-citizen moviegoers and textbook purchasers in developing countries have a lower willingness to pay.

C. Price Discrimination, Arbitrage, and Copyright Exhaustion

While price-discrimination schemes allow sellers to serve buyers with varying willingness to pay, in many cases their feasibility depend on the sellers' ability to prevent arbitrage through resale. Copyright exhaustion, by fostering resale, thus limits the copyright owners' ability to engage in price discrimination.

¹⁰⁹ See CARL SHAPIRO & HAL R. VARIAN, INFORMATION RULES: A STRATEGIC GUIDE TO THE NETWORK ECONOMY 53–82 (1999); TIROLE, *supra* note 103, at 142–43.

¹¹⁰ See SHAPIRO & VARIAN, *supra* note 109, at 53–82. Elasticity of demand measures how price sensitive buyers are. Thus, when the elasticity of demand is low, buyers are not very price sensitive and therefore a change in the price (e.g., a price increase) will cause a modest change in demand (e.g., lower demand). When elasticity is high, buyers are price sensitive and thus every change in price will cause a significant change in demand. In many cases, richer buyers are willing to pay more and have lower elasticity of demand while poorer buyers are willing to pay less and have higher elasticity of demand. This is of course a simplified representation of a much more complex relationship between wealth, willingness to pay, and elasticity of demand.

¹¹¹ TIROLE, *supra* note 103, at 137.

Both second- and third-degree price-discrimination schemes can sometimes be defeated by resale. For example, a software company might bundle together several products and sell them at a discount, hoping to use this second-degree price-discrimination scheme to identify heavy users who might be more price sensitive and offer them cheaper products. An intermediary can defeat this scheme by buying bundled products, unbundling them and sell the products separately.¹¹² Copyright exhaustion, which makes the intermediary's action legal,¹¹³ fosters this price-discrimination defeating practice.

Third-degree price-discrimination schemes are typically even more vulnerable to resale. As explained above, those schemes are based on selling the same product to different buyers for different prices when the buyers are separated by some exogenous attribution.¹¹⁴ It is therefore obvious that if reselling is allowed, then buyers who are part of a subgroup that is identified as having a low reservation price will sell to buyers who are identified as part of a group having a high reservation price.¹¹⁵

The facts of *Kirtsaeng* demonstrate this point. The copyright owner used a type of a third-degree price-discrimination scheme known as international geographic separation, which separates buyers based on the country of purchase.¹¹⁶ Thus, the textbooks that the plaintiff in *Kirtsaeng* sold were significantly more expensive to those who were part of the subgroup identified as having a high willingness to pay (i.e., buyers in developed countries).¹¹⁷ *Kirtsaeng* defeated this scheme by a simple arbitrage: he purchased the product in Thailand, for a price designed for Thai buyers, and resold them to college students in the United States.¹¹⁸ If copyright exhaustion makes this practice

¹¹² Those are the facts of *SoftMan Products Co. v. Adobe Systems Inc.*, 171 F. Supp. 2d 1075 (C.D. Cal. 2001), in which the court found that unbundling the software and selling them separately do not constitute copyright infringement because of the copyright exhaustion doctrine.

¹¹³ *Id.*

¹¹⁴ See *supra* Part III.B.

¹¹⁵ Those are the facts of *Adobe Systems Inc. v. One Stop Micro, Inc.*, 84 F. Supp. 2d 1086 (N.D. Cal. 2000). In that case, the defendant purchased copies of cheap student versions of the plaintiff's product and resold them to the general public. *Id.*

¹¹⁶ See *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1356 (2013).

¹¹⁷ See *id.* Textbooks are used as an example of copyrighted goods that are distributed internationally. However, in some respects, college textbooks are unique. The decision to purchase these books is not being made by those who are paying for them. Indeed, professors pick textbooks, but students pay for them. In addition, from the professors' perspective the cost of switching from one text book to the other is quite substantial. Because of these factors, the competitive pressure on textbook manufacturers to keep price low is limited and the demand very inelastic. A full analysis of these and other unique features of this specific market are beyond the scope of this Article.

¹¹⁸ *Kirtsaeng*, 133 S. Ct. at 1356.

legal, as the Supreme Court held in *Kirtsaeng*, then the ability of copyright owners to engage in geographic price discrimination is significantly limited.¹¹⁹

The distinction between second- and third-degree price discrimination is, in many respects, illusory in this context. In some respects, as discussed above, Kirtsaeng's actions, as fostered by the copyright exhaustion doctrine, limited the publishers' ability to engage in third-degree price discrimination. But, from another perspective, copyright exhaustion limits the publishers' ability in implementing a second-degree price-discrimination scheme. Copyright exhaustion prevents the seller from separating buyers who buy the product just for themselves from buyers who are resellers and who typically have a higher willingness to pay. Copyright exhaustion bundles the copies of the product itself with the right to resell those copies and thus defeats this kind of price discrimination. In other words, if this kind of second-degree price discrimination were feasible, Kirtsaeng's actions would not have troubled the publishing industry. Publishers would continue to sell cheap textbooks in Thailand, which would not include an international right to resell, while offering international resellers like Kirtsaeng a separate license, which would probably be quite expensive. Copyright exhaustion, by giving *all* buyers a right to resell the copyrighted goods they buy, makes such a separation impossible.

Indeed, copyright exhaustion, by making resale legal, can defeat many price-discrimination schemes. The question is whether defeating price discrimination in this way promotes the goals of copyright law. The next section suggests that it typically does not.

¹¹⁹ A more dramatic example of geographic price discrimination of items protected by intellectual property rights is provided by the pharmaceutical industry. This industry sells medicines in developed countries for a price that is significantly higher than the willingness (and ability) to pay of almost all buyers in developing countries. Price discrimination allows the industry to serve both markets. Arbitrage is a problem in this market as well. Therefore, governments and international health organizations spend resources to guarantee that distribution of life saving medicines in developing countries will not endanger the pharmaceutical industry's ability to charge high prices in developed countries. See, e.g., Amy Kapczynski et al., *Addressing Global Health Inequities: An Open Licensing Approach for University Innovations*, 20 BERKELEY TECH. L.J. 1031, 1093 (2005). This phenomenon poses a challenge for those who support broadening the scope of exhaustion of intellectual property. See, e.g., Katz, *supra* note 55, at 78–81 (arguing the pharmaceutical industry is unique); Sarah R. Wasserman Rajec, *Free Trade in Patented Goods: International Exhaustion for Patents*, 29 BERKELEY TECH. L.J. 317, 371–76 (2014) (suggesting that the pharmaceutical industry should be subject to special rules regarding patent exhaustion).

D. *The Welfare Effect of Restricting Price Discrimination*

The previous sections suggest that sellers might want to engage in price discrimination to address the differences in their buyers' demand but that doing so might be inconsistent with the principles of copyright exhaustion. But maybe the limitations on price discrimination are socially desirable? Maybe it is not a bug of the copyright exhaustion doctrine, but a feature? In *Kirtsaeng*, the Court implicitly made that argument:

Wiley and the dissent claim that a nongeographical interpretation will make it difficult, perhaps impossible, for publishers (and other copyright holders) to divide foreign and domestic markets. We concede that is so. A publisher may find it more difficult to charge different prices for the same book in different geographic markets. But we do not see how these facts help Wiley, for we can find no basic principle of copyright law that suggests that publishers are especially entitled to such rights.¹²⁰

This section suggests that there are significant benefits to price discrimination, and therefore one should be hesitant to interpret ambiguous provisions in a way that limits this practice.¹²¹ It will be shown that a rule that fosters price discrimination might be one of those rare instances in which creation can be incentivized without a systematic reduction in access to the work.¹²²

Implementing a price-discrimination scheme affects the price in various markets. In markets that are less sensitive to price changes (low elasticity), the price is expected to increase.¹²³ In *Kirtsaeng*, for example, this was the market for textbooks in the United States. The price change increases the seller's benefits—the producer's surplus (or else the seller would not have chosen to increase prices),¹²⁴ but because of the decrease in quantities, it also increases

¹²⁰ *Kirtsaeng*, 133 S. Ct. at 1370. In *Quality King Distributors, Inc. v. L'anza Research International, Inc.*, the Court made an even stronger statement by suggesting that prohibiting unlicensed importation “would merely inhibit access to ideas without any countervailing benefit.” 523 U.S. 135, 151 (1998) (quoting *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 450–51 (1984)) (internal quotation marks omitted); see also *infra* Part V.A.

¹²¹ See generally William N. Eskridge, Jr., *Overriding Supreme Court Statutory Interpretation Decisions*, 101 YALE L.J. 331, 354 (1991) (exploring the assumption that “legislators are public-regarding—they ‘desire to participate in formulation of good public policy’” (quoting STEVEN KELMAN, *MAKING PUBLIC POLICY: A HOPEFUL VIEW OF AMERICAN GOVERNMENT* 261 (1987))).

¹²² See Kaplow, *supra* note 101, at 1873–78; Rub, *supra* note 17, at 273–75; *supra* Part III.A.

¹²³ Rub, *supra* note 17, at 268.

¹²⁴ This Article, and in particular this section, uses the producer's surplus as a proxy to incentives to create. This is not a perfect proxy because the correlation between the two is not linear. In other words, if the

the deadweight loss and reduces the total social surplus. Indeed, some buyers in those markets that were able to buy the product under the uniform price scheme will be unable to buy it when price discrimination is implemented.

In markets with high elasticity of demand, i.e., with buyers who are more sensitive to price changes (markets with high elasticity, typically markets that are dominated by poor buyers), sellers who implement price discrimination typically choose to reduce prices and increase quantities.¹²⁵ The market for English textbooks in Thailand is an example for such a market. Lowering the prices in such a market increases the producer's surplus (or else the seller would not have chosen to decrease prices), but, because of the corresponding increase in quantities, it also decreases the deadweight loss and increases total surplus. Indeed, some buyers in high-elasticity markets are granted access only because of the reduction in prices under a price-discrimination scheme. In its extreme form, price discrimination does not just increase access in high-elasticity markets, but it opens up markets that otherwise would not have been served without it.¹²⁶ Indeed, it is possible that without price discrimination, publishers would not have sold English textbooks in Thailand at all. With price discrimination, they did.

Therefore, this discussion suggests that implementing price discrimination reduces total surplus in some markets and increases it in others. Economic literature has studied this reality extensively in an attempt to explore whether and when the total deadweight loss, taking all markets into account, decreases or increases. The results are inconclusive.¹²⁷ Pricing some consumers out of low-elasticity markets is troubling because those buyers—who can be thought of as the poor among the rich¹²⁸—typically have a high willingness to pay (although a lower willingness than many other participants in the low-elasticity market). Pricing out buyers with a high willingness to pay significantly

producer's surplus increases by a certain percentage the incentives to create might increase by a different percentage. However, this imperfection should not diminish the claim made in this section. As discussed below, this section suggests that price discrimination causes the producer's surplus to increase in all markets—elastic and inelastic. The section then argues that this guarantees that price discrimination increases the incentives to create. This Article does not assume an exact correlation between the rate of change of the producer's surplus and the rate of change of incentives.

¹²⁵ Rub, *supra* note 17, at 268.

¹²⁶ Elsewhere I have called this phenomenon the “new markets effect.” Rub, *supra* note 17, at 267–68.

¹²⁷ See e.g., TIROLE, *supra* note 103, at 138–39; Fisher, *supra* note 17, at 22–24; Meurer, *supra* note 104, at 57; Rub, *supra* note 17, at 266–71.

¹²⁸ See Rub, *supra* note 17, at 267–68. Those buyers are, for example, poor book buyers in the United States that would be priced out of the market if a publisher implements an international geographic separation scheme that raises prices in developed countries. *Id.*

increases the total deadweight loss. In contrast, price discrimination typically opens up new markets to the seller that would not have been served without it. Price discrimination allows the producer to serve the masses in high-elasticity markets, and it thus typically increases total quantities.¹²⁹ In most cases, those two effects partially cancel each other out, and therefore the overall effect of price discrimination on the deadweight loss and on the access to the work is usually expected to be modest.¹³⁰

Notwithstanding the foregoing, there are cases in which it is likely that price discrimination will improve total surplus and reduce deadweight loss. For example, economic literature suggests that, as the discrepancy between the elasticity (as well as willingness to pay) of different markets increases, it is more likely that the high-elasticity (poor) markets will not be served at all without price discrimination, and therefore price discrimination becomes more likely to reduce the deadweight loss.¹³¹ Finally, in many real-life situations, the poor among the rich are served by specific arrangements that bring them back to the market.¹³² It is therefore not surprising that several empirical studies on the effects of price discrimination in specific markets for information goods showed that such policies decrease the deadweight loss.¹³³

While the possible decrease in the deadweight loss represents improved access to copyrighted works, which is socially desirable, this section makes a significantly more modest claim: price discrimination is socially desirable, even if one does not assume that it decreases the deadweight loss. As discussed

¹²⁹ Economists have proved that an increase in total quantities is a necessary condition for a price-discrimination scheme to reduce the deadweight loss. TIROLE, *supra* note 103, at 138. However, it is not a sufficient condition.

¹³⁰ See Rub, *supra* note 17, at 274–75.

¹³¹ David A. Malueg & Marius Schwartz, *Parallel Imports, Demand Dispersion, and International Price Discrimination*, 37 J. INT'L ECON. 167 (1994).

¹³² See Rub, *supra* note 17, at 272 (explaining how this strategy can reduce the deadweight loss). Public libraries, for example, sometimes reach specific agreements with content providers that allow them to lend digital copyrighted content (which, as further explore below, is not subject to copyright exhaustion) although they are the archetypal “poor among the rich.” Similarly, many pharmaceutical companies implement patient-assistance programs that provide cheaper medicines to noninsured and poor patients in developed countries. See *id.*

¹³³ In one study, economist Julie Mortimer found that the deadweight loss in the DVD market in the US, where discrimination between buyers and renters is almost impossible because of the copyright exhaustion doctrine, is higher than the deadweight loss in Europe, where the limited scope of exhaustion rules allows such discrimination. Julie Holland Mortimer, *Price Discrimination and Copyright Law: Evidence from the Introduction of DVDs* (Harvard Inst. of Econ. Research, Discussion Paper No. 2055, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=636064; see also Phillip Leslie, *Price Discrimination in Broadway Theatre*, 35 RAND J. ECON. 520 (2004) (exploring decreased deadweight loss as a result of price discrimination in Broadway theater).

in Part III.A, a sound copyright policy should strive to incentivize creation with minimal decrease in access. Because price discrimination increases the producer's surplus in all markets—low-elasticity and high-elasticity markets—but has a mixed and typically modest effect on the deadweight loss, it is typically a desirable policy. This is a policy that provides society with a cheap tool to incentivize creation. A tool that incentivizes creation, which, unlike most others, does not decrease access to the information goods.

Therefore, by limiting price discrimination, copyright exhaustion harms copyright policy. It denies the creator incentives without increasing access to the work.¹³⁴

IV. OTHER POSSIBLE JUSTIFICATIONS FOR COPYRIGHT EXHAUSTION

The previous Part explores the effects of copyright exhaustion on authors' incentives to create works and public access to the works created. It suggests that by limiting the copyright owner's ability to engage in some kinds of second- and third-degree price discrimination, copyright exhaustion likely reduces the incentives to create while probably not improving access to copyrighted works. From that perspective, it is likely socially undesirable.

This Part looks at other possible effects of copyright exhaustion to explore whether the doctrine can be otherwise justified in a world without significant transaction costs. This Part thus explores the effects of copyright exhaustion on the following: the pricing schemes used by sellers, the distributive impact of copyright markets and the spillovers they generate, the existence of resale markets, the preservation of old work, and buyers' privacy. This Part concludes that copyright exhaustion might have an undesirable distributive effect, and it can reduce socially desirable spillovers. The social desirability of its impact on the sellers' pricing schemes, on the proliferation of resale markets, and on the preservation of old works is ambiguous. Finally, the doctrine might marginally improve the privacy of buyers, but this effect is quite minimal partly because there seems to be a significant mismatch between the rules of copyright exhaustion and the ways to promote buyers' privacy.

¹³⁴ Elsewhere, I have suggested that in the textbook industry, which was discussed in *Kirtsang*, publishers are likely to serve only the markets in developed countries (e.g., the U.S. market) if the application of copyright exhaustion forces them to charge a uniform price. Therefore, copyright exhaustion in that case denies the publisher the entire income from the Thai market, while it also denies Thai students access to textbooks in English. Rub, *supra* note 20, at 47. Denying access to students also creates an undesirable distributive effect, and it significantly reduces spillovers. See *infra* Part IV.B.

A. Channeling Distribution Schemes

Copyright exhaustion renders certain kinds of arbitrage legal, which makes certain price-discrimination practices difficult to sustain.¹³⁵ However, it does not completely bar price discrimination. Therefore, in some cases, copyright exhaustion does not cause sellers to charge a uniform price, but instead it channels them to use a different kind of price-discrimination scheme, one that cannot be defeated by resale.

Can this channeling function, by itself, justify the doctrine of copyright exhaustion? A close examination reveals that in some cases, forcing a seller to switch from one price-discrimination scheme to another will be socially desirable. In other cases, it can be socially harmful because it might reduce the wellbeing of buyers, or, even if buyers are better off, their increase in welfare might not be enough to offset the decrease in the copyright owner's welfare. Overall, there is no reason to assume that the price-discrimination schemes that sellers will adopt in response to the rules of copyright exhaustion will typically, or even on average, be socially desirable. In fact, it is probably more likely to reduce both incentives and the buyers' welfare.

Take for example the market for movie home viewing. In the European Union, buyers are not allowed to commercially rent copyrighted movies.¹³⁶ Movie studios therefore apply a second-degree price-discrimination scheme to separate libraries and individuals by offering an expensive renting license.¹³⁷ In contrast, copyright exhaustion in the United States, by providing each buyer with a right to commercially rent each copy, makes such a scheme impractical.¹³⁸ Therefore, for many years the studios applied a different second-degree price-discrimination scheme in the United States. The studios first charged a high price for movies, which allowed only commercial renters to purchase them, followed by a significant reduction in prices after several

¹³⁵ See *supra* Part III.

¹³⁶ See *supra* Part I.B.

¹³⁷ Mortimer, *supra* note 133, at 9.

¹³⁸ A few years ago, as a result of a dispute between some studios and several prominent commercial libraries including Redbox and Netflix, the traditional distributing companies (that are typically owned by the studios) stopped distributing films to these libraries. The commercial libraries then started to purchase DVDs at Wal-Mart and rent them out to their patrons. See *Redbox Automated Retail LLC v. Universal City Studios LLLP*, Civil No. 08-766 (RBK), 2009 WL 2588748, at *2 (D. Del. Aug. 17, 2009); *Eddins v. Redstone*, 35 Cal. Rptr. 3d 863, 871–72 (Ct. App. 2005). This dispute ended with the signing of new licensing arrangements between the studios and the libraries. See Wendy J. Gordon, *Intellectual Property as Price Discrimination: Implications for Contract*, 73 CHI.-KENT L. REV. 1367, 1373–74 (1998); Mark A. Lemley, *Contracting Around Liability Rules*, 100 CALIF. L. REV. 463, 481–82 (2012); see also *infra* text accompanying note 264.

weeks, which opened the markets to private purchasers.¹³⁹ This practice was not only detrimental to the studios, but it also denied the purchasing public access to the movies for a long time. The economist Julie Mortimer has concluded that, even without considering the long-term effects on incentives, the scheme used in the United States was socially inferior to the one used in the European Union.¹⁴⁰

The facts of *Kirtsaeng* provide another example. The publisher used to sell textbooks in English for a low price in developing countries and a high price in developed countries. The Supreme Court decision in *Kirtsaeng*, holding that arbitrage between those markets is legal,¹⁴¹ is likely to make this practice unsustainable. What will the publisher do now? It can choose a uniform price, which will lead to a price hike in developing countries and, in practice, will likely make this a product designated for developed countries.¹⁴² Or, it can engage in an alternative pricing scheme. It can, for example, implement second-degree price discrimination by selling different versions of the product in the different countries.¹⁴³ What are the welfare effects of such a change?

From the seller's perspective, this is undesirable. Clearly, if the producer's surplus would have been higher by selling different versions of the textbook in each country, then the seller would have chosen to do so even before the Supreme Court decision in *Kirtsaeng*. However, can there be a situation in which the producer surplus decreases but the total surplus still increases? Under certain conditions, the answer is yes.

For example, it is possible (and quite likely) that the demand for textbooks in English is lower in Thailand than the demand for translated books. However, the publisher might prefer not to spend the resources involved in translating and keeping two versions in print. From the publisher's perspective,

¹³⁹ The reality in recent years might have become more complex because changes in demand altered the preferences of many studios, which then started to release movies to libraries and individuals simultaneously. See Mortimer, *supra* note 133. Later, additional changes in demand caused the studios to alter their practices again and delay distribution to some libraries. See *infra* note 264.

¹⁴⁰ Mortimer, *supra* note 133.

¹⁴¹ *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351 (2013).

¹⁴² Rub, *supra* note 20, at 46.

¹⁴³ These are just some examples of possible actions by the publishers. Additional actions might include distributing more books in digital format, see *infra* Part VI.B, and contractually limiting resale, see *infra* Part VI.D. See also Eric Goldman, *The Supreme Court's First Sale Ruling Will Spur Price Competition in the Short Run, but Enjoy It While It Lasts*, FORBES (Mar. 20, 2013, 11:59 AM), <http://www.forbes.com/sites/ericgoldman/2013/03/20/the-supreme-courts-first-sale-ruling-will-spur-price-competition-in-the-short-run-but-enjoy-it-while-it-lasts/>.

in a pre-*Kirtsaeng* world, it is more desirable to sell textbooks in English in Thailand than it is to translate them. However, in a post-*Kirtsaeng* world, the publisher might not be able to sell textbooks in English in Thailand because of the fear of parallel (i.e., gray market) importation.¹⁴⁴ In that case, the publisher might decide that it is better to engage in price discrimination by translating the book to Thai. It is possible that in such a case the increase in demand in Thailand will increase the consumers' surplus of Thai buyers to a point at which it will outweigh the decrease in the producer's surplus. In that case, the total social surplus will increase.¹⁴⁵

However, there is no reason to assume that this possibly efficiency-enhancing channeling is a likely scenario. Three conditions must be met for this scenario to materialize. First, the increase in the demand for the new product (e.g., the Thai textbook) cannot be too high. If it is, the producer will always supply it, even without copyright exhaustion. This is quite common and can explain why, even before *Kirtsaeng*, many publishers chose to translate books to various languages or to otherwise create a variation between books that are targeted at different markets. Second, the cost of producing the new product must be low enough, or else the publisher will not produce it even with copyright exhaustion. And third, there must be a significant increase in the consumers' surplus that outweighs the decrease in the producer's surplus. If any of these conditions is not met, the limitation that copyright exhaustion places on price discrimination will not channel the publisher to choose an alternative price-discrimination scheme that increases total social surplus by significantly improving access to the product.¹⁴⁶

¹⁴⁴ Gray market importation, also called parallel market importation, is the practice of importing goods from one country to another without the authority of the manufacturer. This is typically done to take advantage of the differences in prices between countries. This is of course what *Kirtsaeng* did. See *supra* Part III.C.

¹⁴⁵ A numeric example might help illustrate this claim: Let's assume that the demand curve for a textbook in English in the United States is given by $Q = 100 - P$; the demand curve for the same textbook in Thailand is $Q = 30 - P$; the demand curve for the same textbook in Thailand translated to Thai is $Q = 50 - P$; and the cost of translation \$500. In that case, before *Kirtsaeng*, the producer would sell the books in English in both markets. The price would be \$50 in the United States and \$15 in Thailand, which would result in producer's surplus of \$2,725, consumers' surplus of \$1,362.50, and total surplus of \$4,087.50. After *Kirtsaeng*, this scheme is unavailable, and so the publisher needs to decide whether and how to serve the Thai market. The publisher knows that by investing \$500 in the translation, it can charge \$25 per book in Thailand for a profit of \$625. The publisher will do it. It will continue to sell the textbook in English for \$50 and will translate and sell the textbook in Thai for \$25. The total producer's surplus will be \$2,625 (lower than the pre-*Kirtsaeng* world). The consumers' surplus is \$1,562.50 (higher than the pre-*Kirtsaeng* world), and the total surplus will be \$4,187.50, which is higher than the pre-*Kirtsaeng* world.

¹⁴⁶ Note that this post-*Kirtsaeng* scenario is efficient only from a static equilibrium perspective. This increase in total surplus is a necessary condition for efficiency but not a sufficient one. As explained in Part III.A, a sound copyright policy should try to provide high producer's surplus with high total surplus (i.e., low

Moreover, there is a real risk that copyright exhaustion will channel the seller to use second-degree price discrimination that is based on *low*-quality products and not *high*-quality products.¹⁴⁷ For example, following *Kirtsaeng*, instead of offering high-quality desirable products in developing countries (e.g., textbooks in Thai), publishers can implement price discrimination by offering low-quality products in those countries, such as cheap, old versions of the textbooks. This possibility is socially troubling: On one hand, it is typically cheap to implement and therefore might be attractive to sellers. On the other hand, the inferior products, now offered in high-elasticity (i.e., poor) markets, shrink that market and cause real social harm. Indeed, if this were the reaction to *Kirtsaeng*, then there would be a decrease in the welfare of the high-elasticity (i.e., poor) buyers, as they will be forced to buy older, and presumably worse, textbooks.¹⁴⁸

There are many examples of price-discrimination schemes that are based on providing intentionally low-quality products to high-elasticity buyers. Software companies, for example, intentionally slow down or add artificial limitations to cheap versions of their software.¹⁴⁹ The pricing decision regarding movie home viewing in the United States also demonstrates this strategy. As discussed,¹⁵⁰ studios responded to the limitation imposed by copyright exhaustion by

deadweight loss). Channeling the seller to use an alternative pricing model reduces the producer's surplus and thus, to a degree, the incentives to create in the long run, and therefore only a significant increase in total surplus can make this policy desirable.

¹⁴⁷ Fisher, *supra* note 17, at 11. It should be noted that in some cases, trademark law can also assist in creating this kind of price-discrimination scheme that is based on selling low-quality goods in poorer countries. Indeed, "U.S. courts . . . have allowed trademark owners to prevent the importation of gray market products when they 'differ materially' from the goods authorized for sale in the domestic market." Irene Calboli, *Market Integration and (the Limits of) the First Sale Rule in North American and European Trademark Law*, 51 SANTA CLARA L. REV. 1241, 1262–63 (2011). However, the prohibition is limited by its purpose, preventing customers' confusion, and, therefore, for example, importation is allowed if the materially different products include a label that states that the importation is not authorized by the trademark owner. *Id.* A full analysis of the limitations to gray market importation that is created by trademark law is beyond the scope of this Article. See *id.*; Mary LaFrance, *Wag the Dog: Using Incidental Intellectual Property Rights to Block Parallel Imports*, 20 MICH. TELECOMM. & TECH. L. REV. 45, 51–57 (2013).

¹⁴⁸ The numeric example, *supra* note 145, can be expanded to illustrate this point. Let's assume that the publisher can, post-*Kirtsaeng*, publish an older version in Thailand. The administrative costs of keeping two books in print are \$10, and the demand of the older books is $Q = 24 - P$. Under these conditions, the publisher will decide to sell the new version for \$50 and the old version for \$12. The producer's surplus will be \$2,634, which is higher than the producer's surplus if the publisher translates the book to Thai (but, of course, lower than it is pre-*Kirtsaeng*). The consumers' surplus will of course shrink (Thai students are now buying old textbooks) to \$1,322, which will result in total surplus of \$3,956, lower than the pre-*Kirtsaeng* surplus.

¹⁴⁹ SHAPIRO & VARIAN, *supra* note 109, at 58–61.

¹⁵⁰ See *supra* notes 138–39 and accompanying text.

implementing a price-discrimination scheme that offered inferior products—late home viewing—to high-elasticity private buyers.

The conclusion is that copyright exhaustion can sometimes channel the copyright owner to adopt a price-discrimination scheme that would not be chosen otherwise. However, it is doubtful that this will improve social welfare. In fact, in many cases, it will not even improve static short-term welfare or even just the welfare of the buyers. Therefore, and because this change reduces the incentives to create, the channeling function of copyright exhaustion cannot justify the existence of copyright exhaustion.

B. Spillovers and Distributive Effect

Information wants to be free. The intangible nature of information makes its flow very difficult to completely control. The indirect benefits that are attributed to the flow of information are even more difficult to control. Monetizing those benefits might even be harder.¹⁵¹ Indeed, information spills over, and in doing so, it creates a positive externality for society—a spillover.

Take, for example a political speech (admittedly, an extreme example). While “I Have a Dream” is a copyright-protected political speech that is owned by the estate of Martin Luther King, Jr.,¹⁵² under no copyright regime can the estate be able to capture the full value of this speech and all the positive externalities that it causes for its listeners. The value of the change that this speech caused spilled over and was enjoyed by society at large.

In a famous essay, Professors Brett Frischmann and Mark Lemley argue that those spillovers are a desirable phenomenon that the law should embrace.¹⁵³ Indeed, it can be argued that the existence of spillovers is part of a social contract in which present creators can enjoy the spillovers from past creators but in return their work should provide spillovers to future creators.¹⁵⁴ The law should foster this social contract.¹⁵⁵

¹⁵¹ See, e.g., Yochai Benkler, *Free as the Air to Common Use: First Amendment Constraints on Enclosure of the Public Domain*, 74 N.Y.U. L. REV. 354, 433–35 (1999); Brett M. Frischmann & Mark A. Lemley, *Spillovers*, 107 COLUM. L. REV. 257 (2007); R. Polk Wagner, *Information Wants to Be Free: Intellectual Property and the Mythologies of Control*, 103 COLUM. L. REV. 995 (2003).

¹⁵² Estate of Martin Luther King, Jr., Inc. v. CBS, Inc., 194 F.3d 1211 (11th Cir. 1999).

¹⁵³ Frischmann & Lemley, *supra* note 151.

¹⁵⁴ See RADIN, *supra* note 24, at 170–73.

¹⁵⁵ Without legal intervention, this social contract might be subject to a collective action problem. While creators as a group might desire a certain level of spillovers, if each of them is free to control the externalities

The existence of spillovers has a complex effect on copyright policy. While spillovers are typically correlated to access, this correlation is not perfect, especially because some consumers and some ways to use information goods create more spillovers than others. Therefore, society should be more concerned with limiting access to certain types of work and certain types of consumers. For example, political speeches or information goods used in our educational system typically create more desirable spillovers than pop songs. Similarly, buyers who use information goods to create other information goods¹⁵⁶ generate more spillovers than buyers that do not. Some of the doctrines of copyright law, and in particular the fair use defense, seem to specifically target those spillover-rich works and consumers.¹⁵⁷

Copyright exhaustion seems different.¹⁵⁸ Unlike the fair use defense, it does not target spillovers-rich usage—possibly to the contrary. First, as Part III.D shows, copyright exhaustion typically does not increase total access to the work. Second, by limiting price discrimination, it denies access for many individuals with lower willingness to pay and grants access to some buyers, typically fewer, with a higher willingness to pay. Even if on average the total welfare is unchanged, it is doubtful if this is a good proxy for spillovers. In fact, it is possible, and even likely, that denying access to a large group of low-paying buyers will reduce spillovers more than the increase attributed to a small group of high-paying buyers.¹⁵⁹ If that is the case, then restricting price discrimination will likely reduce spillovers. For example, if as a result of the decision in *Kirtsaeng*, access to English textbooks is denied for many students in Thailand,¹⁶⁰ then it is likely that overall spillovers are reduced, even if some American students (with higher willingness to pay) are granted access.¹⁶¹

from his or her own work, he or she might try to reduce the spillovers from the work (i.e., monetize use by others) below their socially efficient level.

¹⁵⁶ Creating information goods requires access to existing works. Jessica Litman, *The Public Domain*, 39 EMORY L.J. 965, 966 (1990) (“To say that every new work is in some sense based on the works that preceded it is such a truism that it has long been a cliché [sic] . . .” (footnote omitted)).

¹⁵⁷ See Frischmann & Lemley, *supra* note 151, at 286–90.

¹⁵⁸ Cf. Robinson, *supra* note 5, at 1454, 1479 (arguing that limitation on fair use might harm the balance between private and public rights more than restriction on copyright exhaustion).

¹⁵⁹ In other words, all else being equal, it is likely that on average a buyer whose willingness to pay is x creates a spillover that is lower than twice the spillover of a buyer, typically poorer, whose willingness to pay is $x/2$. See BRETT M. FRISCHMANN, *INFRASTRUCTURE: THE SOCIAL VALUE OF SHARED RESOURCES* 72–79 (2012).

¹⁶⁰ This scenario is possible. See *supra* note 134.

¹⁶¹ It is actually quite unlikely that the holding in *Kirtsaeng* will improve the access to textbooks for American students. Rub, *supra* note 20, at 47.

Third, in sharp contrast with the fair use defense,¹⁶² copyright exhaustion applies equally to all buyers, and it does not target buyers who generate more externalities, such as future creators.

This discussion points to another significant shortcoming of copyright exhaustion: the limitation on price discrimination might cause a regressive socially undesirable distributive impact. As explored in Part III.D, price discrimination typically improves access for those with high elasticity of demand and low willingness to pay, who are typically poor, while it deteriorates the access to buyers with low elasticity of demand and high willingness to pay, who are typically rich. This transfer of surplus from the rich to the poor is desirable from a distributive justice perspective as well as from an efficiency perspective.¹⁶³

Therefore, it seems that copyright exhaustion creates an undesirable regressive distributive effect and quite likely reduces the desirable spillovers from the distribution of copyrighted works.

C. *Developing Resale Markets*

Some have suggested, sometimes implicitly, that copyright exhaustion is socially desirable because it facilitates secondary markets.¹⁶⁴ For example, in *Kirtsaeng*, during oral argument Justice Breyer expressed a somewhat similar view when he suggested that the publisher's position might lead to "millions of Americans who buy Toyotas [that will be unable to] resell [their cars] without getting the permission of the copyright owner of every item in that car which is copyrighted."¹⁶⁵ Analogous concerns were later conveyed in Justice Breyer's majority opinion in the case.¹⁶⁶

¹⁶² See, e.g., *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 579 (1994) (holding that transformative use—one that "adds something new"—is entitled to broader fair use protection); Frischmann & Lemley, *supra* note 151, at 286–90.

¹⁶³ See Fisher, *supra* note 17, at 25, 29–30 (explaining the desirability of price discrimination from a distributive justice perspective); see Rub, *supra* note 73, at 100–01 (explaining how the decrease in marginal utility of wealth means that transference of surplus from rich to the poor, even when total wealth is held constant, increases total utility and is socially desirable, all else being equal).

¹⁶⁴ See, e.g., Reese, *supra* note 9, at 586.

¹⁶⁵ Transcript of Oral Argument at 28–29, *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351 (2013) (No. 11-697), available at http://www.supremecourt.gov/oral_arguments/argument_transcripts/11-697.pdf.

¹⁶⁶ *Kirtsaeng*, 133 S. Ct. at 1365 ("A geographical interpretation would prevent the resale of, say, a car, without the permission of the holder of each copyright on each piece of copyrighted automobile software.").

Robust secondary markets are typically socially desirable because they reduce waste and because they give potential purchasers another buying option.¹⁶⁷ Indeed, if, for example, a book can be used for a year before its physical condition deteriorates and makes it useless, and if each owner would like to hold on to it for three months, it is socially undesirable to force the first owner to either keep the book or discard it. This, among other things, will require the production of additional books instead of saving those production costs by reusing the existing one.

While the connection between secondary markets and copyright exhaustion is complex, the former can certainly exist and flourish without the latter. The concern expressed by the Supreme Court and the view that makes the existence of secondary markets contingent on broad copyright exhaustion ignores the power of the market and its ability to serve the needs of buyers and sellers.¹⁶⁸ Specifically, because secondary markets increase the value of information goods in their initial sale, it is in the initial sellers' interest to provide such a license and to make sure that secondary markets are innovative and robust.

It is not hard to find examples of sellers who facilitate secondary markets, even when the law does not mandate them to do so. In fact, Toyota itself makes the service plan that comes with the purchase of a car transferable, while it is under no legal obligation to do so. The reason for this choice is not a secret. Toyota's website explicitly states that the service plan is transferable "as an added resale value."¹⁶⁹ Therefore, even if *Kirtsaeng* would have been

¹⁶⁷ In that respect, secondary markets provide a type of price discrimination, because it separate buyers who want new expensive products from those who prefer used cheaper products. A related argument for the desirability of secondary markets is that they reduce the costs of information goods and thus improve access to the goods. See, e.g., Mark A. Lemley & Mark P. McKenna, *Is Pepsi Really a Substitute for Coke? Market Definition in Antitrust and IP*, 100 GEO. L.J. 2055, 2116 (2012); Reese, *supra* note 9, at 585–86. The discussion in Part III.D, as well as the discussion in Part VI.B, suggest that the merits of this claim might be questionable. While the initial seller of information goods, typically the copyright owner (e.g., publisher or record company), might lose sales because of secondary markets, this loss would be taken into account in the determination of the initial price of the good. In other words, sellers that know that their products will be resold will charge more than sellers who know that their products will not, *ceteris paribus*. The buyers who know that they can resell an item will also be willing to pay more. Therefore, resale, in itself, does not always reduce prices. In addition, because copyright exhaustion does not allow the seller to distinguish (and price discriminate) between buyers that will resell the product and those that will not, the two groups are charged the same price, which means that the non-resellers are paying a higher price because they are cross-subsidizing the resellers.

¹⁶⁸ In some respects, this position is a reminder of Ronald Coase's words: "It was of course the view of the judges that they were affecting the working of the economic system." R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 10 (1960). As Coase demonstrated, however, in many instances that is not the case, and the market works around the relevant legal rules. See *id.*

¹⁶⁹ *FAQ*, TOYOTA CERTIFIED, <http://www.toyotacertified.com/faq.html> (last visited Feb. 7, 2015).

decided differently, it is almost certain that a license to resell would be provided to every buyer of every car. Otherwise, car sellers would face a sharp decrease in consumers' demand and willingness to pay.

Toyota is not alone. In many markets, the scope of the right to resell is significantly broader than the scope of copyright exhaustion. For example, the End User License Agreements that Adobe uses, which characterize the transaction between the company and its consumers as a mere license and not a sale in order to avoid the full impact of copyright exhaustion,¹⁷⁰ contractually allow the consumer to "permanently transfer" their rights.¹⁷¹

Reselling and renting rights not only increase the value of the item in its initial sale, but they also allow the copyright owner to make an additional profit. Thus, while copyright exhaustion does not apply to digital work,¹⁷² examples of licensed digital renting services are abundant. Services such as Netflix streaming, Amazon Instant Video, iTunes, Pandora, Spotify, YouTube Movies, and many more, are flourishing in recent years and have increased their share in the markets for information goods. Although every download of every digital movie and every digital song must be covered by a license, this does not seem to make this market weak or slow to innovate. More and more digital service providers now offer new services that expand the ways in which their products can be used. Amazon's Kindle for example now allows buyers of digital books to lend them to others,¹⁷³ and it is reported that the company might start allowing Kindle users to resell their books.¹⁷⁴

It is important to note that innovative resale and renting markets can also emerge under the auspices of copyright exhaustion. Netflix's mail delivery of DVDs, Redbox's automated DVD-rental kiosks, eBay, and Craigslist are just a few examples of such services whose operation depends on the doctrine of copyright exhaustion. The argument made in this section is more modest. Neither theory nor practice shows that copyright exhaustion is a required

¹⁷⁰ *SoftMan Prods. Co. v. Adobe Sys. Inc.*, 171 F. Supp. 2d 1075 (C.D. Cal. 2001); *Adobe Sys. Inc. v. One Stop Micro, Inc.*, 84 F. Supp. 2d 1086 (N.D. Cal. 2000); *see also infra* Part VI.E.

¹⁷¹ ADOBE, SOFTWARE LICENSE AGREEMENT § 4.6.2 (2011) <http://www.adobe.com/content/dam/Adobe/en/legal/licenses-terms/pdf/CS6.pdf>.

¹⁷² *See infra* Part VI.B.

¹⁷³ *Lend or Borrow Kindle Books*, AMAZON, <http://www.amazon.com/gp/help/customer/display.html?nodeId=200549320> (last visited Feb. 7, 2015).

¹⁷⁴ In January 2013, Amazon secured a patent on the resale of digital content. U.S. Patent No. 8,364,595 (filed May 5, 2009) (issued Jan. 29, 2013).

condition for having robust or innovative resale markets. This is, therefore, a weak justification for copyright exhaustion.

D. Preserving Old Works

Can copyright exhaustion be justified as a tool to preserve old copyrighted works? This section suggests that copyright exhaustion, which was originally designed primarily to promote competition policy, is an inefficient tool to promote preservation.

There is little doubt that the preservation of creative works is socially desirable. Creative works have artistic and historic value. They hold an important part of our cultural DNA. Some old works “might one day find renewed commercial, popular, or critical interest” and they will be able to exploit “[n]ew markets and technologies [that] allow wider dissemination and exploitation.”¹⁷⁵ Other old works might help inspire and promote the creation of new works.

Although preservation is desirable, there is no consensus as to the best way to promote it.¹⁷⁶ Some have suggested that copyright exhaustion promotes preservation.¹⁷⁷ Two main arguments have been made to link copyright exhaustion and preservation. First, by improving access to the work and increasing the quantities of work distributed, copyright exhaustion increases the chance that older copies will survive over time.¹⁷⁸ Second, copyright exhaustion encourages buyers to resell works instead of discarding them, and it, in particular, allows libraries, which are experts in preservation, to access the work.¹⁷⁹

The discussion in Part III.D suggests that copyright exhaustion might not improve access to the work. In fact, by limiting price discrimination and

¹⁷⁵ Reese, *supra* note 9, at 608.

¹⁷⁶ The analysis of this issue goes beyond the scope of copyright exhaustion. Commentators disagree whether copyright protection in itself promotes or disturbs preservation. Some argue that copyright law incentivizes copyright owners to preserve their works while others argue that without copyright protection some market participants will be free to preserve historical works. *See, e.g.*, Eldred v. Ashcroft, 537 U.S. 186, 207 (2003) (suggesting the Congress extended copyright protection to, among other things, incentivize the preservation and restoration of old movies); Paul J. Heald, *How Copyright Keeps Works Disappeared*, 11 J. EMPIRICAL LEGAL STUD. 829 (2014) (suggesting that works that fall into the public domain are available in greater numbers).

¹⁷⁷ *See, e.g.*, Perzanowski & Schultz, *supra* note 5, at 895 (“[F]irst sale enables preservation of public access to works that are no longer available from the copyright owner.”); Reese, *supra* note 9, at 603–10.

¹⁷⁸ Reese, *supra* note 9, at 604–06.

¹⁷⁹ *Id.* at 606–08.

possibly by reducing waste, copyright exhaustion likely reduces the quantities of copies sold and the diversity among buyers, which is expected to harm long-term preservation.¹⁸⁰

Copyright exhaustion can also promote preservation by allowing buyers to resell their copies and by incentivizing libraries to hold significant collections.¹⁸¹ However, these benefits are limited. First, copyright owners have a clear interest in preserving their work.¹⁸² Therefore, even without copyright exhaustion, copyright owners will typically permit actions that promote the preservation of their work. As explained in Part III.C, it is also likely that they will permit the resale of their work, as it increases the value of the work in the initial market. However, because copyright exhaustion bundles together the right to resell and rent with the ownership of the physical copy, it cross-subsidizes these actions¹⁸³ and thus libraries in general. It is difficult to know whether these benefits outweigh the harm that copyright exhaustion causes to preservation by reducing quantities.

Even if the net effect of copyright exhaustion on preservation is positive, this is a weak justification for the doctrine. First, it is extremely overbroad, because most of the actions it actually fosters, such as the resale of new and popular books or music or the renting of commercially successful movies, has little to do with the preservation of old works. Second, it is also extremely too narrow. Many actions that are crucial for effective preservation of creative works have nothing to do with copyright exhaustion. For example, the most significant preservation initiatives in recent years involve mass digitalization. Those initiatives consist of scanning and saving a massive number of books. The legality of mass digitalization is questionable and it is currently the subject of several lawsuits.¹⁸⁴ However, the question in these cases is whether libraries and other commercial entities can scan and save copyrighted books, which revolves around the exclusive right of reproduction. The exclusive right of reproduction has nothing to do with the scope of copyright exhaustion. It is

¹⁸⁰ There is tension between the two suggested goals of copyright exhaustion: improving preservation and reducing waste. This Article suggests that copyright exhaustion reduces waste by encouraging buyers to resell their work. However, it should be conceded that by doing so copyright exhaustion reduces the number of copies of a work in circulation and thus increases the chances that a work will not be preserved.

¹⁸¹ Reese, *supra* note 9, at 607.

¹⁸² *Id.* at 608.

¹⁸³ See *supra* note 167.

¹⁸⁴ See, e.g., Authors Guild, Inc. v. HathiTrust, 755 F.3d 87 (2d Cir. 2014) (holding that the mass digitalization of old books is fair use); Authors Guild, Inc. v. Google Inc., 954 F. Supp. 2d 282 (S.D.N.Y. 2013) (reaching the same conclusion).

therefore not surprising that the decisions on mass digitalization initiatives have focused on the fair use defense and not on copyright exhaustion.

Therefore, although preservation is socially important, copyright exhaustion is an inadequate tool to promote it. It is possible that copyright law should include specific rules that foster preservation,¹⁸⁵ and it is also possible that the fair use defense already achieves this goal. Whatever the effective solution to the problem of preservation might be, copyright exhaustion is just ill-equipped to provide it.

E. Protecting Buyers' Privacy

Some commentators have justified copyright exhaustion as a tool that promotes buyers' privacy.¹⁸⁶ This section suggests that while copyright exhaustion can, in some cases, promote this social goal, it is an inefficient and ineffective way to do so. It will be shown that copyright exhaustion is, in many cases, significantly too broad to promote privacy, while in other respects it is desperately too narrow. Therefore, other legal tools are better tailored to promote privacy.

There is little doubt that privacy is socially desirable and that there are clear advantages to giving individuals control over the distribution of some of their personal information. Copyright exhaustion promotes privacy by fostering a secondary market in copyrighted works that might be free from the control of the copyright owner.

Consider, for example, the ability to engage in certain intellectual activities, such as reading a book, in anonymity.¹⁸⁷ This ability is important because the decision to engage in such activities (e.g., to read a certain book), can sometimes reveal sensitive private information. For example, the decision to read a book about dealing with cancer might disclose that there is a reasonable likelihood that the reader, or maybe his or her close family member, is battling cancer. More broadly, intellectual privacy—the ability to keep the records of

¹⁸⁵ These mechanisms may include, for example, rules that will allow orphan works to fall into the public domain or rules that would allow libraries to scan old books.

¹⁸⁶ See, e.g., Perzanowski & Schultz, *supra* note 5, at 896 (“Under the doctrine, consumers can transfer works without permission of the copyright holder, thereby allowing them to do so privately and anonymously.”).

¹⁸⁷ See generally Julie E. Cohen, *A Right to Read Anonymously: A Closer Look at “Copyright Management” in Cyberspace*, 28 CONN. L. REV. 981 (1996) (discussing the need to allow users to consume digital content without being subject to privacy-invasive copyright management systems).

one's intellectual activities private and confidential—is important for promoting the First Amendment values of free thought and expression.¹⁸⁸ Therefore, there is real social value in allowing individuals to keep their reading lists, as well as other records of intellectual consumption, to themselves.

Copyright exhaustion promotes these goals. For example, it allows an individual battling cancer to walk into a used-book store and buy a book without having any record of that action. Without copyright exhaustion, such a transaction would have to be authorized by the copyright owner, which can compromise the action's otherwise private nature. This benefit is especially salient in the digital world. Without copyright exhaustion, every copy of a copyrighted work will likely be sold in the primary market by copyright owners or their distributors,¹⁸⁹ which would give copyright owners access to the identity of all the buyers of their works.

While this argument has merit, it is also overstated. As explained in Part III.C, resale markets can and do exist even without copyright exhaustion. It was explained that in many cases, especially when it comes to physical (and not digital) copies, even without copyright exhaustion, the initial seller will allow future resale to increase the price paid in the initial transaction.¹⁹⁰ While it is possible that without copyright exhaustion, in some cases, the copyright owner might not grant an *ex ante* license to resell and will require further negotiation and more information, this is probably the exception to the rule. Moreover, even when the initial seller does not permit resale (or other forms of transferability), the seller might still not keep track of the identity of its buyers.¹⁹¹ Indeed, market pressure is expected to somewhat curtail the initial

¹⁸⁸ See Neil M. Richards, *Intellectual Privacy*, 87 TEX. L. REV. 387 (2008).

¹⁸⁹ As further explained in Part VI.B, while in the physical world, even without copyright exhaustion, most copyright owners would allow buyers to resell the work, this is less likely to happen in the digital world. Because the production of digital copies is almost costless, the benefits of reusing old copies are negligible as the copyright owner can sell a “new copy” to any new buyer.

¹⁹⁰ Moreover, as further explored in Part V, the seller will typically prefer to include such a license *ex ante*, in the initial sale, and not *ex post*, on the eve of the resale transaction, because *ex post* negotiation is expensive. See also *infra* note 208.

¹⁹¹ Indeed, while some sellers might find it valuable to know the identity of their buyers (in the primary and secondary markets), anonymous consumption can sometime be (and currently is) allowed even when transferability is not. For example, many prominent online eBook sellers, including Amazon and eBooks.com, while not allowing transferability of eBooks, do not verify the identity of a purchaser as a condition for a sale. And while the identity might be known in many cases because most purchasers probably pay with their credit cards, those who pay with other payment methods, such as gift cards or prepaid cards, can typically buy digital books in anonymity. Similarly, libraries routinely purchase licenses that allow them to let their patrons read

sellers' attempts to collect information regarding buyers' identities, especially when the work is of sensitive nature. Thus, authors and distributors of books on battling cancer will likely be encouraged to allow anonymous purchase, as it will improve their sales.

More importantly, even if one believes that preserving anonymity in those cases in which the initial sellers' policies will endanger it is a vital social goal, this is a weak justification for copyright exhaustion. From a privacy perspective, copyright exhaustion is significantly too broad because most actions that are shielded by copyright exhaustion—such as commercial importation, resale of popular music CDs, or yard sales—have little to do with privacy concerns.

In other respects, from a privacy perspective, copyright exhaustion is too narrow because even when it does improve privacy, such an improvement is overall minimal. Indeed, copyright exhaustion only marginally promotes intellectual privacy. Much of our intellectual activities, such as our phone conversations or our online search terms—have little to do with copyright policy. Thus, while copyright scholars raise concerns regarding the privacy of the records of our intellectual activities and suggest that it is being threatened in recent years,¹⁹² copyright exhaustion does little to elevate these concerns. Copyright exhaustion might make it somewhat more difficult for Amazon to know what books users read but it does not prevent Google from collecting that information and much more.¹⁹³ From a privacy perspective there is no real

electronic books without reporting the identity of those readers to the publisher. *See infra* text accompanying note 253.

¹⁹² *See, e.g.*, Richards, *supra* note 188, at 434–36 (explaining the importance of guarding information regarding online activity because “[i]ntellectual records—such as lists of Web sites visited, books owned, or terms entered into a search engine—are in a very real sense a partial transcript of the operation of a human mind”).

¹⁹³ In practice, it is not obvious that even if digital copies were subject to the rules of copyright exhaustion, which currently they are not, *see* Part VI.B, Amazon and other commercial distributors would be significantly restricted in their ability to monitor readership. As further discussed in Part VI.B, digital copies are typically distributed with digital rights management systems that might collect information about the users' activities. Even if these right management systems are required to allow transferability (if and when the rules of exhaustion apply to digital content) it is unclear that they will be precluded from recording these activity. Copyright exhaustion in itself does not prevent data collection. Second, digital files, in many cases, are used through communication devices that can collect information on the users' readership. Thus, even if eBooks would have been subject to the rules of exhaustion, privacy might not improve if most buyers, including in the secondary market, use Amazon's Kindle to read eBooks. Finally, even when copyright exhaustion denies some information from the initial distributor, it does not prevent the resellers from collecting that information. This might make the utility of exhaustion as a privacy enhancing rule questionable, especially when initial sellers play a dominant role in the facilitation of secondary markets, as Amazon does with respect to the resale of used physical books.

reason for this distinction. It is therefore not surprising that privacy scholars suggest solutions to the problem of intellectual privacy and anonymous reading that have nothing to do with copyright exhaustion.¹⁹⁴

Indeed, while copyright exhaustion can limit some flows of private information, it seems that those benefits are quite peripheral. Copyright exhaustion was designed to promote goals that have little to do with privacy (or, more broadly, with the flow of information in general), and it is thus not surprising that it is ill-equipped to effectively or significantly protect our intellectual privacy. Therefore, the problem of privacy, especially in the digital world, should be addressed by other, better tailored, legal mechanisms.

V. THE BENEFITS OF COPYRIGHT EXHAUSTION: REDUCING TRANSACTION COSTS

The previous Parts of this Article questioned many of the potential justifications for the copyright exhaustion doctrine. Part II shows that due to developments in economics and in the law, the historic theoretical foundations of the doctrine no longer support it. Parts III and IV suggest that in a world with no information costs, in which buyers can, without incurring any costs, know the attributes of the products they purchase, the justifications for copyright exhaustion are weak. The doctrine likely decreases the incentives to create; does not increase access to the work; has marginal desirable effect on the privacy of buyers; and, because it specifically harms poor buyers, is likely to have an undesirable distributive impact, and harms spillovers.

However, this no-information-costs world is not the world we are living in.¹⁹⁵ This Part relaxes the assumption of no information costs and, by doing so, it reveals the role of copyright exhaustion as an information-costs-reduction

¹⁹⁴ See, e.g., Cohen, *supra* note 187, at 1031–34 (suggesting that anonymous reading should be secured by governmental regulation of copyright management systems); Richards, *supra* note 188, at 437 (arguing the intellectual privacy should be protected vis-à-vis online service providers by new laws that would impose certain obligations regarding the retention and management of users' information as well as by social norms that will cultivate privacy).

¹⁹⁵ Some have attributed to Coase the practice of ignoring transaction costs. This is sometimes referred to as a “Coasian world.” Historically, nothing of course can be further from the truth. Coase's lifelong work shed light on the effects of transaction costs. Exploring a no-transaction-costs hypothetical, as done by Coase and as done in the previous Part of this Article, only to later relax that assumption, is designed to shed light on the role of transaction costs and not to ignore them. See also Brett M. Frischmann & Alain Marciano, *Understanding the Problem of Social Cost* (Cardozo Legal Studies Research Paper No. 435, 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2445819 (explaining how Coase was often misunderstood).

norm.¹⁹⁶ In other words, this Part suggests that the main benefit and justification for copyright exhaustion should be the reduction of information costs. Section A discusses the significance of information costs and how copyright exhaustion affects them. Section B suggests that copyright markets might experience high information-costs problems but that some participants in this market, namely professional repeat players, are significantly less likely to be significantly harmed by these costs. The next Part, Part VI, shows how these observations can help shape the scope of copyright exhaustion.

A. *Copyright Exhaustion and Information Costs*

Previous Parts of this Article, and in particular Part IV.C, suggest that when buyers determine the value of a copyrighted good, they take into account, among other things, their legal rights to the purchased items, and in particular whether they will be allowed to resell or rent these items in the future. The doctrine of copyright exhaustion standardizes this information.¹⁹⁷ In other words, under this doctrine, copyrighted products can be resold and rented, and buyers in the market can determine the value they attach to these products with that information in mind.¹⁹⁸

Put differently, without copyright exhaustion, buyers would need to spend resources investigating whether they would be allowed to resell and rent a work, or else it would be difficult to assess the value of the copyrighted products. The resources that are spent in this inquiry—a form of information costs—are not earned by anyone. They are a social waste. Minimizing them is therefore socially desirable.

Moreover, when information costs are high, buyers might choose not to spend them at all and just buy the product “as is.” This is troubling. If buyers do not know if the copyrighted products they are buying can be transferred (i.e., resold and rented), their purchasing decisions cannot incentivize the

¹⁹⁶ See, e.g., Perzanowski & Schultz, *supra* note 7, at 2082; Van Houweling, *supra* note 5.

¹⁹⁷ Others have explored how standardization of property arrangements can reduce information cost. See, e.g., Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 *YALE L.J.* 1, 31–33 (2000) (suggesting that certain property law doctrines such as the *numerus clausus* principle can be explained by the need to reduce information costs by standardization).

¹⁹⁸ This standardization is partial because even under copyright exhaustion the market is mixed because the resale of items that were not initially legally sold, such as pirated items, is illegal. This fact was practically ignored during the *Kirtsaeng* litigation and it was not mentioned in the decision. It is possible that the low volume of pirated goods in the market makes it less severe.

sellers to offer resale rights.¹⁹⁹ This might encourage the sellers to sell inferior products (i.e., products that do not allow resale) for a price that is suitable for superior goods (i.e., products that allow resale).²⁰⁰

In extreme cases, when a market includes goods of varying quality that the buyers cannot easily tell apart, a phenomenon known as “the market for lemons” might emerge.²⁰¹ Buyers in this market will price products based on their expected (average) value. This average price will typically be too low for sellers of high-quality goods but attractive for sellers of low-quality goods. Therefore, some high-quality sellers will leave the market, and more low-quality sellers will join it. This, in turn, will decrease the willingness to pay even further, which will cause more high-quality sellers to leave the market and so on. In such a case, the inability to observe the products’ quality destroys the market for high-quality goods.

This phenomenon is troubling in any market,²⁰² but it is especially troubling in the context of resale markets. As Part IV.C explains, resale rights prevent waste, and therefore limiting resale rights seems especially undesirable (to sellers as well as buyers and to society at large). Indeed, the right to resell information goods should typically be included in the bundle of rights that is transferred upon the initial sale of these goods.²⁰³ However, without copyright exhaustion, once a market for lemons emerges there is a strong incentive to provide low-quality goods: in this case, copyrighted items that cannot be resold.

Similar arguments were raised before the Supreme Court in *Kirtsaeng*. Kirtsaeng and his amici described a series of undesirable scenarios that would materialize if he were to lose the case. During litigation, these scenarios were

¹⁹⁹ Cf. *supra* Part IV.C (suggesting that it is in the sellers’ best interest to offer product that can be resold because this will increase prices in the initial sale).

²⁰⁰ This is part of a broader problem. It can be argued that whenever buyers cannot verify a certain important attribution with respect to items they consider purchasing, seller will not have enough incentive to offer efficient products. See *infra* note 277 and accompanying text for a discussion on this problem in the context of standard-form agreements.

²⁰¹ See Akerlof, *supra* note 19.

²⁰² See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673–74 (1984) (discussing the phenomenon in the context of securities law); Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 244 (1995) (discussing the phenomenon in the context of boilerplate provisions in contract law); Carol M. Rose, *The Several Futures of Property: Of Cyberspace and Folk Tales, Emission Trades and Ecosystems*, 83 MINN. L. REV. 129, 149 (1998) (discussing the phenomenon in the context of regulation of cyberspace).

²⁰³ Van Houweling, *supra* note 73, at 562.

referred to as “the parade of horrors.” While some of those “horrors” are questionable,²⁰⁴ the publisher’s position was indeed problematic from an information-costs perspective. Its position, adopted by the dissenting justices, was that the unauthorized importation, as well as the unauthorized domestic resale of copyright protected items *manufactured abroad*, constitutes copyright infringement. However, all the parties to this litigation agreed that unauthorized importation as well as unauthorized resale of copyright-protected items *manufactured in the United States* are perfectly legal.²⁰⁵

Adopting the publisher’s position would have resulted in domestic resale markets that include two types of products: products that can be legally resold and products the resale of which triggers liability for copyright infringement. Those infringing sellers would have been subject to extensive remedies, including statutory damages,²⁰⁶ and the facilitators of those markets (e.g., eBay) would have faced potential liability for indirect copyright infringement.²⁰⁷

As discussed above, markets that consist of products of varying quality in which buyers cannot cheaply observe the quality can be unstable and can inefficiently shrink. In this case, this might have created a chilling effect not only on secondary markets but also on initial markets. Indeed, initial markets might shrink because buyers may either assume that they will not be able to resell items they purchase, which will reduce their willingness to pay, or they will waste resources in guaranteeing that resale rights will be available to them.

This problem is, of course, broader than the issue that was before the Supreme Court in *Kirtsaeng*. Without copyright exhaustion, buyers will need a license from the copyright owner to resell copyright-protected goods. Thus, resale rights, which are generally efficient as they eliminate waste, will not be provided by law by default. Getting out of this inefficient default rule will require broad licensing schemes, which is wasteful from an information-costs perspective.²⁰⁸ Those licensing schemes might create many idiosyncratic

²⁰⁴ See, e.g., *supra* text accompanying notes 165–69; *infra* note 233.

²⁰⁵ This is the holding of *Quality King Distributors, Inc. v. L’anza Research International, Inc.*, 523 U.S. 135 (1998). No party in *Kirtsaeng* asked the Court to reconsider the *Quality King* precedent. See also *infra* Part VI.A.

²⁰⁶ 17 U.S.C. § 504(c) (2012).

²⁰⁷ See *infra* note 235 and accompanying text.

²⁰⁸ A funny and effective example of such a negotiation was presented in a segment on *The Colbert Report* in which Stephen Colbert and Elvis Costello agreed, after several minutes of negotiation, that if Colbert sells an old Costello record for \$1 in a garage sale, he would pay Costello 14 cents and a dented muffin tin. The sketch was enacted as part of the show’s “Judge, Jury & Executioner” series. *The Colbert Report: Jake*

arrangements, and choosing among them will be expensive. Moreover, as Professors Thomas Merrill and Henry Smith explained, idiosyncratic arrangements that run with the property create an externality for all others who deal in the same kind of property, as they need to inquire into the nature of their interests too.²⁰⁹ Indeed, law and economics scholars have long argued that default rules should typically mimic the arrangement that is the most efficient to most parties,²¹⁰ and that providing default rules that invite many parties to contract around them is socially undesirable.²¹¹ Thus, the need to minimize contracting and reduce information costs can justify a norm that allows buyers of copyrighted goods to resell those copies.

B. Identifying High-Information-Cost Scenarios

Section A suggests that copyright exhaustion can reduce information costs. Therefore, eliminating copyright exhaustion might be disadvantageous because high information costs are socially wasteful and can lead to undesirable consequences. This section complements the discussion in section A by arguing that in the market for copyrighted goods information costs are typically high, but situations in which the market can mitigate them can be identified. This discussion will be the base for several normative implications that are explored in Part VI.

Tapper (Comedy Central television broadcast Nov. 26, 2012), available at <http://thecolbertreport.cc.com/videos/242ato/judge--jury---executioner---copyright-law>. This is an example of high transaction costs in the secondary market for copyrighted goods. This Part focuses on information costs in the primary market because, to a large degree, it sees the problem of transaction costs in the secondary market as a subset of the problem of information costs in the primary market. Part IV.C suggests that even without the doctrine of copyright exhaustion, absent any information costs, many, possibly most, copyrighted goods will be offered with the future right to transfer the goods and therefore transaction costs in the secondary markets will be, to a large degree, eliminated too.

²⁰⁹ Merrill & Smith, *supra* note 197, at 31–33. Robinson disagrees with Merrill and Smith, and suggests that as the idiosyncratic arrangements become more common, buyers will expect them and will require the sellers to secure their rights. Robinson, *supra* note 5, at 1487. While I agree that in some cases Robinson is correct, see *supra* Part III.C, Robinson seems to minimize the information costs of this situation, and especially, as further explained in Part V.B, the disproportionate effect it will have on low-volume transactions.

²¹⁰ Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 93 (1989) (“Lawmakers can minimize the costs of contracting by choosing the default that most parties would have wanted.”).

²¹¹ In fact, in some cases default rules that are inefficient for many contracting parties might result in real social harm because they tend to be sticky and cause some parties to be stuck with arrangements that would not have been chosen in the absence of those default rules. See Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 *FLA. ST. U. L. REV.* 651 (2006).

Several common characteristics of the markets for copyrighted goods are expected to increase information costs—the cost of figuring out whether a buyer will be able to resell a copyrighted good—at least when copyright exhaustion is inapplicable. The main attribute that makes information costs significant in the context of copyrighted goods is that those goods are typically cheap and that they frequently and rapidly change hands.²¹² Indeed, information costs are less troubling the more expensive the product purchased.²¹³ The reason is that information costs do not closely correlate to the value of the item purchased. Thus, if *Kirtsaeng* would have been decided differently, the absolute cost of exploring the buyers' rights with respect to a \$1 used music CD would have been comparable to the cost of exploring the rights with respect to a \$100,000 painting, but their effects would be different. A few dollars in information costs might not seriously affect the purchase of an expensive painting, but similar expenses would have a real chilling effect on the markets for cheap CDs.²¹⁴

In some cases, there are mechanisms that can mitigate the information costs problem. For example, information costs can be mitigated by a registry of rights, which will provide notice to buyers.²¹⁵ However, while registration

²¹² Christina M. Mulligan, *The Cost of Personal Property Servitudes: Lessons for the Internet of Things* 11–15 (Brooklyn Law Sch., Legal Studies Paper No. 400, 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2465651 (last modified Dec. 19, 2014).

²¹³ *Id.*; Robinson, *supra* note 5, at 1486; Van Houweling, *supra* note 5, at 914–15.

²¹⁴ This is somewhat similar to the process of clearing title, which is common in real estate transactions. While this process is not cheap in absolute terms, those costs are negligible compared to the value of a typical real estate transaction. Robinson also compared the process of buying real estate that is subject to a servitude to the process of buying a copyrighted work subject to a restriction, Robinson, *supra* note 5, at 1491, but he might not have fully appreciated the difference between adding some information costs to a large real estate transaction and to a small transaction over cheap copies.

²¹⁵ See Rub, *supra* note 73, at 75–76 (discussing the role of registration in reducing information costs); Van Houweling, *supra* note 5 (same). Currently, in the United States, a copyright can be voluntarily registered with the U.S. Copyright Office, but this registration encompasses only the interests in the intangible work, not in the physical copies thereof. Thus, the registry discussed in this section is different than the registry currently in place.

It can be argued that registering rights in copies might be difficult. Christina Mulligan, for example, argued that transaction costs might be higher with respect to items that are small, movable, and fungible, such as most copies of copyrighted work. Mulligan, *supra* note 212, at 9–11. While this is probably a valid observation, it might be a real concern only to the extent that copies will vary in the rights they confer on their possessor. Thus, if two (or more) otherwise identical copies of HARRY POTTER AND THE SORCERER'S STONE confer different rights on their possessors then effectively registering and tracing these legal rights might be difficult. A registry will need to have an entry for each copy and each buyer will need to be able to identify his or her own copy in that registry. However, if the rights do not vary among copies, this problem is significantly mitigated. Thus, if *all* the copies of HARRY POTTER AND THE SORCERER'S STONE include the same limitation on the possessors' rights, then registering this limitation and, from the buyers' perspective, locating and learning about this limitation will be significantly easier. Modern digital technology can reduce the costs of

might mitigate the problem in some cases, it is not a panacea for the information costs problem in the context of copyrighted goods because, like most notice systems, it is not costless to implement. It is therefore unlikely that registration can be used to efficiently verify rights in every CD or book sold in the marketplace.²¹⁶

While high information costs might be significant in the markets for information goods, some market participants can handle them better than others and significantly reduce them. In this respect, a distinction should be made between professionals and laymen. Professional repeat players not only engage in large volume transactions, but they can develop expertise in ways to cheaply investigate the attributes of products they regularly purchase. Indeed, it is significantly less likely that professionals will be unfamiliar with their legal rights. Therefore, copyright exhaustion might have only marginal benefits in reducing the information costs of professionals. Interestingly, in all the high-profile copyright-exhaustion decisions from recent years, the alleged copyright infringers were professionals in the sense that they were sued for repeated acts of alleged infringement on a large scale.²¹⁷ Information costs did not play a role in any of those cases.

registration even further. Rub, *supra* note 73, at 76. Of course, as discussed in this section, even if effective registration is feasible, requiring the buyers of cheap and frequently transferable products to explore a registry might be socially undesirable from an information-costs perspective.

²¹⁶ Cf. Hovenkamp, *supra* note 9, at 516–21 (placing a significant weight on registration as a way to provide notice and reduce information costs); Mark R. Patterson, *Must Licenses Be Contracts? Consent and Notice in Intellectual Property*, 40 FLA. ST. U. L. REV. 105, 147–52 (2012) (discussing the limited role of notice in the enforcement of licenses on downstream buyers); Robinson, *supra* note 5, at 1486–87 (discussing the need to require sellers to give notice to buyers).

²¹⁷ Supap Kirtsaeng made a small fortune from selling textbooks that he knew had a notice, which stated they were not to be sold in the United States. *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1356 (2013). His business model was based on selling copyrighted goods in the United States that the copyright owner wanted to be left out of that market. Similarly, Timothy Vernor, who unsuccessfully raised copyright exhaustion in *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010), *SoftMan*, which successfully raised this claim in *SoftMan Products Co. v. Adobe Systems Inc.*, 171 F. Supp. 2d 1075 (C.D. Cal. 2001), and *One Stop Micro*, which failed in making a very similar argument in *Adobe Systems Inc. v. One Stop Micro, Inc.*, 84 F. Supp. 2d 1086 (N.D. Cal. 2000), were all engaged in massive sales of copyrighted software online. Costco, the defendant in *Costco Wholesale Corp. v. Omega, S.A.*, 562 U.S. 40 (2010) (per curiam) (mem.), is the second largest retailer in the United States. Quality King Distributors, which successfully raised copyright exhaustion when sued in *Quality King Distributors, Inc. v. L'anza Research International, Inc.*, 523 U.S. 135 (1998), is a company that engaged in importation to the United States on a large scale for over fifty years. Troy Augusto, who successfully relied on copyright exhaustion in *UMG Recordings, Inc. v. Augusto*, 628 F.3d 1175 (9th Cir. 2011), regularly purchased and distributed CDs that included a promotion statement prohibiting resale, and ReDigi, whose copyright exhaustion defense was denied in *Capitol Records, LLC v. ReDigi Inc.*, 934 F. Supp. 2d 640 (S.D.N.Y. 2013), operated a large online digital record store. It is of course possible that other cases, and in particular cases that settled prior to adjudication, involved laypersons.

The conclusion is that in many cases, copyright exhaustion can be justified as a tool to reduce information costs. This is especially true when the rules of the exhaustion doctrine make it unnecessary for laypersons to inquire whether they will be able to resell and lend copyrighted goods they consider buying. In other cases, information costs are expected to be less significant, and so the justification for copyright exhaustion is weaker. The next Part of this Article suggests that by comparing these benefits with the costs of copyright exhaustion, the scope of copyright exhaustion can be shaped.

VI. NORMATIVE IMPLICATIONS: REBALANCING COPYRIGHT EXHAUSTION

The previous Parts explore the complex economic effects of copyright exhaustion. This doctrine, *inter alia*, makes price discrimination more difficult, which in turn typically reduces the incentives to create without increasing the access to the work and brings about an undesirable distributive effect. The doctrine might also reduce the spillovers from the distribution of creative works. At the same time, the doctrine reduces information costs, and therefore, when these costs are expected to be high, the doctrine might be socially desirable.

The significance of each of those factors—incidences and information costs, and to a lesser degree, access, distributive impact, and spillovers—and the other considerations that were explored throughout this Article should shape the scope of the copyright-exhaustion doctrine. In other words, a sound copyright policy will dictate a narrow scope to the doctrine in those cases in which it creates significant harm to socially desirable goals, such as incentivizing creation, all else being equal. Similarly, it will be advisable to expand the scope for copyright exhaustion when its benefits, such as reducing information costs, are significant. Therefore, the effects of copyright exhaustion on these factors should dictate its scope.

This Part shows how this balanced framework can tackle the core questions that collectively shape the scope of copyright exhaustion.²¹⁸ This Part addresses those five core questions: (1) whether the copyright exhaustion

²¹⁸ The approach taken in this Part tries to identify situations in which, on average, copyright exhaustion should be broader or narrower than it currently is. A possible different approach would leave this determination to a flexible, case-by-case judicial determination. This is the approach with respect to the enforcement of servitudes on chattels, restraints on alienation of property, and vertical restraints in general. *See supra* Part II. This approach, while not without merits, leads to uncertainty, which seems especially harmful in the dynamic market of information goods. Indeed, it seems socially undesirable to make transactions over information goods, which are extremely frequent in the digital world, subject to ex post judicial scrutiny.

doctrine should apply to importation in the same way that it should be applied to domestic resale, (2) whether it should apply to digital distribution of copyrighted materials, (3) whether it should apply to commercial renting, (4) whether a copyright owner might have a contractual cause of action when copyright liability is excluded by copyright exhaustion, and (5) whether the scope of the doctrine should be dictated by an attempt to characterize certain transaction as a mere license instead of a sale. These questions—which, in recent years, have been the subject of a heated debate in litigation and in academic writing—can be addressed by the balanced approach suggested by this Article.²¹⁹

A. *Importation and Domestic Resale*

It is well settled that copyright exhaustion limits copyright owners' ability to control domestic redistribution of their works. However, it is not clear whether copyright exhaustion should limit the ability of copyright owners to control international importation of copyrighted goods into the United States. This debate concerns the ambiguous language of the Copyright Act as well as questions on the desirable control that copyright owners should exercise from a copyright policy perspective.²²⁰

It is hard to conclusively know whether a copyright owner can control importation of copyrighted goods into the United States by just examining the relevant provisions of the Copyright Act. At least three sections of the Copyright Act are at play here: Section 106(3) that stipulates the exclusive right of distribution,²²¹ Section 602(a)(1) that states the copyright owner's exclusive right over importation,²²² and Section 109(a) that codifies the copyright exhaustion doctrine.²²³ The text of the Copyright Act does not clarify how these three provisions relate to one another and, in particular, whether

²¹⁹ These questions are complex, and the discussion in this Part cannot address every argument that was raised in connection to each one of them. This Part therefore outlines the main arguments and considerations that should be taken into account when designing full solutions to these questions.

²²⁰ Other countries debate similar questions, and it is the subject of international negotiation over copyright. *See, e.g.,* GHOSH, *supra* note 33; Kaminski, *supra* note 4.

²²¹ 17 U.S.C. § 106(3) (2012) (“[T]he owner of copyright under this title has the exclusive rights . . . to distribute copies . . . of the copyrighted work to the public . . .”).

²²² *Id.* § 602(a)(1) (“Importation into the United States, without the authority of the owner of copyright under this title, of copies . . . of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute copies . . . under section 106 . . .”).

²²³ *Id.* § 109(a) (“[T]he owner of a particular copy . . . lawfully made under this title . . . is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy . . .”).

Section 109(a) (copyright exhaustion) limits just Section 106(3) (domestic distribution) or also Section 602(a)(1) (importation).²²⁴

In *Quality King*, the Supreme Court unanimously resolved this difficulty by holding that copyright exhaustion, as codified in Section 109(a), shields not just domestic distribution but also importation.²²⁵ Recently, in her concurring opinion in *Kirtsaeng*, Justice Kagan implicitly criticized this holding.²²⁶

The analysis in the previous Parts provides strong support for Justice Kagan's position. Indeed, while the Court in *Quality King* noted that prohibiting unlicensed importation "would merely inhibit access to ideas

²²⁴ The language of the relevant sections of the Copyright Act is ambiguous, and it can entertain several different ways to reconcile the copyright exhaustion doctrine in Section 109(a) with the rights of importation in Section 602(a)(1). For example, it can be argued that when Section 602(a)(1) states that unauthorized importation infringes on "the right to distribute," it incorporates the limitations on that right of distribution and, in particular, the copyright-exhaustion doctrine. Alternatively, it can be argued that because Section 109(a) states that an owner of a copy is entitled "to sell or otherwise dispose of the possession of that copy" but says nothing about importation, then it does not restrict Section 602(a)(1). One can find additional support for both interpretations in various parts of the Copyright Act as well in its legislative history. *See generally* L'anza Research Int'l, Inc. v. Quality King Distribs., Inc., 98 F.3d 1109 (9th Cir. 1996) (explaining why Section 109(a) does not limit Section 602(a)(1)), *rev'd*, 523 U.S. 135 (1998); Sebastian Int'l, Inc. v. Consumer Contacts (PTY) Ltd., 847 F.2d 1093 (3d Cir. 1988) (explaining why Section 109(a) limits Section 602(a)(1)).

This Article focuses on the desirable scope, from a copyright policy perspective, of the copyright-exhaustion doctrine, and therefore it does not explore all the arguments for one statutory interpretation over another. Suffice to say that the Copyright Act itself is ambiguous enough to support the various conclusions that courts have read into these provisions throughout the years.

²²⁵ *Quality King*, however, left one question unanswered: whether copyright exhaustion applies to items that were both manufactured and first sold abroad and later imported, without the copyright owner's authority, to the United States. 523 U.S. 135. In *Kirtsaeng v. John Wiley & Sons, Inc.*, the Court answered this question and held that copyright exhaustion applies in this situation. 133 S. Ct. 1351 (2013). Therefore, under current precedent, copyright exhaustion applies to importation regardless of the location of manufacturing or first sale. *See also supra* note 40.

²²⁶ *Kirtsaeng*, 133 S. Ct. at 1372–73 (Kagan, J., concurring). Justice Kagan stated that she thought that the publisher "may have a point" when suggesting that Section 602(a)(1)'s "rightful function [is] enabling copyright holders to segment international markets" and therefore this "gives [her] pause about *Quality King*'s holding that the first-sale doctrine limits the importation ban's scope." *Id.* at 1373. Justice Kagan explained that the Copyright Act allows interpretation different from the one the Court adopted in *Quality King*. She also conceded that the combined effect of the decisions in *Quality King* and *Kirtsaeng* limits Section 602(a)(1) "to a fairly esoteric set of applications" but observed that "if Congress views the shrinking of § 602(a)(1) as a problem, it should recognize *Quality King*—not [*Kirtsaeng*]—as the culprit." *Id.* at 1372. She also suggested that "allowing the copyright owner to restrict imports irrespective of the first-sale doctrine—i.e., reversing *Quality King*—would yield a far more sensible scheme of market segmentation." *Id.* at 1373 n.2.

It therefore seems that Justice Kagan agreed with the publisher that Congress tried to foster international price discrimination, and she implicitly suggests that the Court was wrong in holding, in *Quality King*, that copyright exhaustion applies to importation. Justice Kagan's concurring opinion was joined by Justice Alito. Neither Justice Kagan nor Justice Alito was a member of the Court in 1998 when *Quality King* was decided.

without any countervailing benefit,”²²⁷ this Article suggests that the reality is quite different and more complex. Indeed, prohibiting unlicensed importation might not inhibit access to copyrighted goods²²⁸ and might actually provide a “countervailing benefit.”

By using the framework developed in the previous parts of this Article, a more careful policy analysis can be offered. Such an analysis would balance the benefits and harms from extending copyright exhaustion to importation and compare it to the benefits and harms from the domestic implementation of this doctrine. As analyzed below, this balanced approach leads to the same conclusions implied by Justice Kagan’s concurring opinion in *Kirtsaeng*: domestic resale and importation should be treated differently.

For several reasons, it seems desirable to allow a copyright owner to control importation. First, the impact on incentives must be considered. As Part III shows, if copyright exhaustion applies to importation, international price discrimination, which is extremely lucrative to copyright owners because of the significant global differences in willingness to pay, becomes more difficult. This will decrease, possibly significantly, the incentives to create.²²⁹ Second, the effect on access should be considered. Part III demonstrates that

²²⁷ *Quality King*, 523 U.S. at 151 (quoting *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 450–51 (1984)) (internal quotation marks omitted).

²²⁸ While the statement quoted from *Quality King* considered limitation on “access to ideas,” this was probably a mistake. Ideas are not protected by copyright, 17 U.S.C. § 102(b), and therefore the scope of copyright exhaustion should not materially affect access to ideas. Therefore, it is reasonable to assume that the Court was referring to the possible limitation on access to copyrighted goods.

²²⁹ The need to incentivize the creation of information goods should distinguish copyright owners from other sellers. Indeed, the law grants market power to copyright owners in order to incentivize creation. Importation rights are part of that scheme. With most other products, there is no economic justification to grant market power by law. See Guy A. Rub, *The Unconvincing Case for Resale Royalties*, 124 YALE L.J. F. 1, 3–5 (2014). Therefore, while this Article suggests that copyright owners should be granted an exclusive right over importation, the analysis does not justify granting similar rights to producers of other goods.

Producers should also not be allowed to use the importation rights of copyright owners to enforce price discrimination on products that are not protected by copyright. Unfortunately, in two of the recent Supreme Court cases dealing with copyright exhaustion, producers have tried to do so. In *Quality King*, the plaintiff manufactured shampoo and argued that the label on the bottle is protected by copyright, and therefore the bottles could not be imported. 523 U.S. at 138–140. In *Costco Wholesale Corp. v. Omega, S.A.*, 562 U.S. 40 (2010) (per curiam) (mem.), the plaintiff manufactured watches that were not protected by copyright or patents. It argued that a tiny logo on the back of the watch was protected by copyright, and thus the watches could not be imported to the United States. See *Omega S.A. v. Costco Wholesale Corp.*, —F.3d—, 2015 WL 235479, at *4 (9th Cir. 2015) (Wardlaw, J., concurring) (discussing the Omega “Globe Design”). Regardless of the scope of copyright exhaustion, importing L’anza shampoo bottles or Omega watches should not trigger liability for copyright infringement, and those actions should be safeguarded by other doctrines in copyright law such as fair use, copyright misuse, and the de minimis defense. See *id.* at *6–12 (refusing to enforce Omega’s copyright in the globe design because it constitute copyright misuse).

eliminating price discrimination does not generally increase access to copyrighted goods.²³⁰ In fact, when it comes to importation, there is a high likelihood that price discrimination improves access because of the significant differences in willingness to pay across markets. When these differences are significant, some high-elasticity markets, in this case markets in third-world countries, can typically be served only if a price-discrimination scheme is implemented.²³¹ Therefore, eliminating price discrimination in those cases typically reduces overall access.

Third, the distributive impact and the effect on spillovers should be evaluated. As explained in Part IV.B, there is no reason to assume that geographic price discrimination targets creators or other consumers or usages generating significant positive externalities. Therefore, as explained in Part IV.B, because unrestricted, unauthorized importation can lead to reduced quantities, it might also reduce spillovers. It was also explained that eliminating price discrimination can be especially harmful to poor buyers—in this case buyers in developing countries—which is undesirable from both utilitarian and distributive justice perspectives.

Fourth, the possible reduction in information costs should be measured. It seems that requiring a license to import copyrighted goods is expected to have only a modest effect on information costs. Importation is typically handled in large quantities by professionals, who, as analyzed in Part V.B, usually face low information costs.

Small-scale private importation, which can be adversely affected by allowing the copyright owner to control importation, is not only less common, but, more importantly, it can also be (and to a large degree currently is) covered by a specific defense.²³² Indeed, it seems unnecessary and

²³⁰ It should be noted that if the question of access is limited to just United States consumers, the result may be more complex. Because the United States is one of the richest countries in the world, eliminating international price discrimination might reduce prices domestically while increasing them in other countries. It is doubtful that this was the intent of the Supreme Court in *Quality King* or *Kirtsaeng*. Moreover, in many cases, even this change is unlikely. It is implausible that the *Kirtsaeng* decision, for example, will lead to a reduction in prices of textbooks in the United States. Publishers, if forced to make a choice, will likely prefer to keep prices high, even if that means losing practically all sales in developing countries. Rub, *supra* note 20, at 46–47.

²³¹ See Malueg & Schwartz, *supra* note 131.

²³² The Supreme Court in *Kirtsaeng* was concerned that a ruling for the publisher in that case would have prevented private importation. See *infra* note 233. Even if one perceives private importation as very important, these concerns seem greatly overstated. First, 17 U.S.C. § 602(a)(3)(B) states that importation of one copy for the private use and not for distribution and importation of copies that form part of the personal baggage of

unreasonable to allow Costco, Kirtseang, and the like to make millions in international arbitrage just to preserve low information costs so that some would be able to buy a single book in Europe for their spouses.²³³

Applying the same framework to domestic resale markets leads to different results. In domestic markets, copyright-exhaustion doctrine typically has only modest effects on incentives. Geographic segmentation is not broadly used domestically, and even when it is, it does not bring about significant profits, partly because the differences in consumer willingness to pay among various markets are not significant. Those smaller differences might also increase the likelihood that price discrimination, when used, will limit access.²³⁴ Therefore, because the limitations on price discrimination are modest, and because access is not expected to be harmed by the application of copyright exhaustion to domestic markets, it also should not cause meaningful undesirable distributive effect or significantly reduce spillovers.

In contrast, requiring a license for any domestic resale significantly increases transaction costs. Many resellers in domestic resale markets are laymen who engage in resale sporadically and on a small scale. They might be individuals who sell their possessions on eBay, Craigslist, or in yard sales. As explained in Part V.B, requiring them to spend resources to inquire about their future resale rights or to secure a license will raise information costs significantly and create a powerful chilling effect on those markets, and then on the initial markets as well. In addition, unauthorized resale transactions,

someone arriving to the United States is not an infringement of copyright. Second, there are other mechanisms in the Copyright Act that shield against liability for private importation, in particular the fair use defense. 17 U.S.C. § 107. Although private importation is non-transformative, it is also noncommercial and because the transaction costs of securing a license for such a minor activity are high, the market harm to the copyright owner seems negligible. Therefore, applying the four-factor test of Section 107 should lead to the finding of no liability. Indeed, the fair use defense is designed to, among other things, deal with situations of high transaction costs such as private importation. See Wendy J. Gordon, *Fair Use as Market Failure: A Structural and Economic Analysis of the Betamax Case and Its Predecessors*, 82 COLUM. L. REV. 1600, 1627–30 (1982). Such an action might also be considered de minimis. See also *infra* note 233.

²³³ Some of the scenarios that were part of “the parade of horrors” in *Kirtsaeng* involved private importation. During oral argument Justice Sotomayor asked whether the publisher’s position means that one cannot buy a book in England and bring it as a gift to his wife in the United States. Transcript of Oral Argument, *supra* note 165, at 27. Similar concerns appeared in the majority opinion. *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1365 (2013) (“[U]nder [the publisher’s position] a contemporary tourist who buys, say, at Shakespeare and Co. (in Paris), a dozen copies of a foreign book for American friends might find that she had violated the copyright law.”). The analysis in this Part suggests that the Court is not just likely wrong in reading the Copyright Act, see *supra* note 232, but that from a policy perspective it is a weak justification for the massive commercial importation of *Kirtsaeng* and the like.

²³⁴ See Malueg & Schwartz, *supra* note 131.

once they occur, might make the facilitators of those resale markets (eBay itself or the owner of a physical market in which used copyrighted goods are resold) liable for secondary copyright infringement,²³⁵ which will further chill these markets. Because resale of physical items is typically desirable,²³⁶ this chilling effect is detrimental to social welfare. In fact, contrary to the current scope of copyright exhaustion, a copyright policy that is committed to reducing information costs should allow unauthorized resale even with respect to copyrighted goods that were illegally imported to the United States. Otherwise, the information costs in investigating the origin of an item and the circumstances in which it was imported will be very high.²³⁷

Therefore, there is a strong economic justification to the position taken in Justice Kagan's concurring opinion in *Kirtsaeng*. Copyright exhaustion should be applied differently to importation and domestic resale. Importation, subject to the exceptions on private importation, should require a license.²³⁸ Domestic resale should not.

B. *Digital Exhaustion*

Copyright exhaustion applies to physical items but not to digital files. Transferring a digital file requires the creation of a new copy, which violates the copyright owner's exclusive right of reproduction.²³⁹ This conclusion holds even if the transferor's copy is deleted. Recently, in *Capitol Records, LLC v. ReDigi, Inc.*, a district court held that the transfer of digital music files constitutes both reproduction and distribution of a copyright-protected work,

²³⁵ See *Fonavisa v. Cherry Auction, Inc.*, 76 F.3d 259, 265 (9th Cir. 1996) (a company that operates a market in which unlicensed copies are regularly sold is liable for indirect copyright infringement). The doctrines of secondary liability for copyright infringement are complex, especially with respect to online sites, as they are partly shielded by the Digital Millennium Copyright Act. See 17 U.S.C. § 512. A full analysis of the potential liability of online marketplaces, like eBay, had *Kirtsaeng* been decided differently, is thus nontrivial and beyond the scope of this paper.

²³⁶ See *supra* text accompanying note 167.

²³⁷ Allowing free transfer of copies that were illegally imported will weaken the ability of copyright owners to fight illegal importation because it will eliminate any incentives of domestic buyers in tracing the origin of the goods they purchase. However, this seems like a necessary evil in order to reduce information costs in domestic markets.

²³⁸ As explained above, see *supra* text accompanying note 39, a regime in which a copyright owner can control importation is called national exhaustion. The analysis in this section thus supports such a regime, but in some circumstances it can also support a regional exhaustion regime, similar to the one in the European Union. See *supra* text accompanying note 41. Indeed, when countries in one region have similar economic attributes, the harm from restricting price discrimination within the region is small, while applying exhaustion might encourage intra-region trade by reducing information costs.

²³⁹ 17 U.S.C. § 106(1) (2012).

which is not protected by either fair use or copyright exhaustion.²⁴⁰ This decision is consistent with the position taken by the Copyright Office in a 2001 study.²⁴¹ Many have criticized this position and called for a broader interpretation of copyright exhaustion under current law and for a change in the law that will provide effective copyright exhaustion in the digital world.²⁴² The increase in the volume of digital distribution of copyrighted goods,²⁴³ which is expected to be further encouraged by the Supreme Court's decision in *Kirtsaeng*,²⁴⁴ brings this question to the forefront of copyright discourse.²⁴⁵ The Internet Policy Task Force within the Department of Commerce is currently conducting a study on the topic.²⁴⁶

While this Article does not question that more and more copyrighted works are expected to be distributed digitally and thus, under current law, not to be covered by the copyright-exhaustion doctrine, it doubts that this will negatively affect social welfare. Indeed, the framework developed in this Article explains

²⁴⁰ 934 F. Supp. 2d 640, 652–56 (S.D.N.Y. 2013). In that case, the court found that copyright exhaustion did not apply because the files were first transferred from the seller to a third party's server and then to the buyer. Because the transfer from the seller to the third party was an infringement of the exclusive right of reproduction, any future transfers of that file, including to the buyer, would not be covered by copyright exhaustion, which only applies to "lawfully made" copies. Therefore, in contrast, copyright exhaustion might apply in a direct transfer from a seller to a buyer. However, in practice, this will have no effect. Copyright exhaustion is a defense only with respect to the right of distribution, and therefore a transfer of a digital file will always infringe the exclusive right of reproduction. It should be noted that the decision in *ReDigi* is inconsistent with that of the European Court of Justice, which recently held that the principles of copyright exhaustion apply in the distribution digital software. Case C-128/11, *UsedSoft GmbH v. Oracle Int'l Corp.* 2012 E.C.R. I-0000, available at <http://eur-lex.europa.eu/legal-content/EN/TEXT/PDF/?uri=CELEX:62011CJ0128>.

²⁴¹ U.S. COPYRIGHT OFFICE, DMCA SECTION 104 REPORT 78–105 (2001), available at <http://www.copyright.gov/reports/studies/dmca/sec-104-report-vol-1.pdf>. That study concluded that as a matter of current law, copyright exhaustion applies only to physical copies, and as a matter of policy, that law should not be changed.

²⁴² E.g., Asay, *supra* note 21, at 21–23; Lemley & McKenna, *supra* note 167, at 2116 (arguing that copyright exhaustion has an important role in restricting the power of the copyright owner); Perzanowski & Schultz, *supra* note 5. *But see* Volokh, *supra* note 21, at 830–32 (explaining how the control that publishers have over digital distribution can allow them to offer cheaper textbooks to students). This section suggests, *inter alia*, that Professor Volokh is correct and that it is not obvious that expanding copyright exhaustion will limit the market power of copyright owners in a way that will reduce prices and promote social welfare. *See also supra* note 167.

²⁴³ *See* Volokh, *supra* note 21, at 823.

²⁴⁴ *See* Asay, *supra* note 21, at 23.

²⁴⁵ *See* Maria A. Pallante, *The Next Great Copyright Act*, 36 COLUM. J.L. & ARTS 315, 331–32 (2013) (a lecture by the Register of Copyrights of the United States and Director of the U.S. Copyright Office discussing the possibility that Congress will revise the Copyright Act to deal with exhaustion with respect to digital distribution).

²⁴⁶ COPYRIGHT IN THE DIGITAL ECONOMY, *supra* note 3, at 35–37.

that digital exhaustion might cause more harm than good, especially because it has the potential to cause massive damage to incentives.

Digital exhaustion might lead to piracy, which will naturally harm incentives. Indeed, when Anne transfers a physical book to Bob, as the copyright-exhaustion doctrine allows her to do, he gets to possess the book and she does not. If both of them would like to read the book at the same time, they will need to purchase another copy. Even if copyright exhaustion applies to digital books, Anne will obviously not be legally allowed to “transfer” a copy to Bob while keeping a copy for her own use. However, doing so is feasible in the digital world and in fact not very difficult, and so the temptation might be too big. In that respect, digital exhaustion might foster piracy.

Moreover, there is a clear conflict between promoting digital exhaustion and the current legal regime, which encourages the use of Digital Rights Management devices (DRMs) as a tool to reduce piracy. DRMs are electronic tools that are typically attached to files containing copyrighted works and limit the users’ actions with respect to the file, including the reproduction and distribution thereof. The circumvention of DRMs is typically illegal.²⁴⁷ Because DRMs can prevent transfer of digital files, any practical implementation of copyright exhaustion in the digital world would require regulating and limiting DRMs.²⁴⁸ However, because DRMs are an important tool in the fight against online piracy, regulating them or limiting their scope of protection might not be trivial and might encourage online piracy and discourage copyright owners from using modern methods of digital distribution.²⁴⁹

However, even if—somehow—the problem of piracy can be solved, copyright exhaustion is expected to cause significant harm to incentives. To appreciate this damage, one must observe that used digital works provide a perfect substitute for new copies because they do not naturally wear and tear. That means that some copies will be used by many buyers along the chain of digital possession, which, as will be further explained below, will significantly

²⁴⁷ 17 U.S.C. § 1201 (2012) (providing, *inter alia*, that, subject to certain exceptions, circumvention of DRMs that control access to copyrighted work, as well as the manufacturing or trafficking in any technology or product that is designed for circumventing DRMs that restrict access, copying, or distribution of copyrighted works, is illegal).

²⁴⁸ See Perzanowski & Schultz, *supra* note 7, at 2120–23 (suggesting that circumventing DRMs, to facilitate actions that should be shielded by copyright exhaustion, should be allowed).

²⁴⁹ DRMs pose serious challenges to various information-goods policies, such as fair use and privacy. A full analysis of these problems is far beyond the scope of this Article.

harm the market share of the copyright owner. The Copyright Office made this point clear:

Time, space, effort and cost no longer act as barriers to the movement of copies, since digital copies can be transmitted nearly instantaneously anywhere in the world with minimal effort and negligible cost. The need to transport physical copies of works, which acts as a natural brake on the effect of resales on the copyright owner's market, no longer exists in the realm of digital transmissions. The ability of such "used" copies to compete for market share with new copies is thus far greater in the digital world.²⁵⁰

Because digital copies can be distributed indefinitely, copyright owners cannot know or even reasonably estimate how many buyers along the chain of distribution will use each copy they sell. Therefore, and because copyright exhaustion does not allow discrimination between heavy and light users, sellers will have significant difficulties in determining the price of digital copies. This, in turn, can create a real chilling effect on the initial distribution of digital work and on the incentives to create.

This claim can be illustrated by examining the market for textbooks. Let's assume that exhaustion applies to digital textbooks, which means that buyers can freely transfer a digital textbook as they please, although they are not allowed to create two simultaneously accessible copies of one purchased textbook. Some buyers will buy the digital textbook just for their own personal use. As with physical books, others will buy the textbooks for their usage (e.g., during one semester) but will resell it afterwards. Those copies might continue to change hands indefinitely.²⁵¹ In addition, because changing possession of a digital file is so easy, many students will share digital books. In fact, some commercial entities can provide those services on a large scale. Consider, for example, a company that will buy digital copies of a textbook and sell a subscription service to use them. Whenever a student needs the textbook, the student's computer automatically borrows it from the company, the student reads it, and then, automatically, the computer returns the possession of the digital book to the company. Because few people read the same textbook at the exact same time, the company can probably buy only a few dozen copies but serve hundreds of students. This will cause substantial harm to the market of the copyright owner. It might discourage the publisher from even publishing

²⁵⁰ U.S. COPYRIGHT OFFICE, *supra* note 241, at 82–83.

²⁵¹ This of course encourages publishers to release frequent updates to their textbooks, even when it is socially inefficient to do so. *See* Volokh, *supra* note 21, at 830–31.

digital textbooks, thus denying society this convenient and non-wasteful mode of distribution.²⁵²

This social harm is caused because copyright exhaustion, if applicable in the digital world, denies the producer the ability to price discriminate between the light-usage students, those who purchased the book for personal use, and the heavy-usage user, the commercial renting company. If price discrimination is allowed—in other words, without copyright exhaustion—the copyright owner can solve this problem by charging the company a price that reflects its massive usage. In fact, nowadays, when digital unauthorized distribution is illegal, that is exactly what publishers do. They sell digital books to libraries under a specific license, which allows the libraries to grant access to many of their patrons.²⁵³

Once one appreciates the significant harm to incentives, the question becomes whether other factors can provide significant benefits that would outweigh this harm. Copyright exhaustion, which, as analyzed in Part III, is a price-discrimination-defeating tool, is not expected to significantly improve access or spillovers. In fact, the analysis above suggests that it might discourage digital distribution, which might lower access to the work and thus spillovers.²⁵⁴ In addition, in the digital world there is practically no waste.²⁵⁵ If Marshall purchased a digital book, society will lose nothing if, once he finishes with the book, he discards it, and Taney, who also wants to read the book, purchases another “copy” from the copyright owner. No wasteful production of an additional book is required. The copyright owner, as the initial seller of the good, is able to efficiently price it, setting a price that reflects the inability of buyers to resell the good.

Limiting copyright exhaustion to the physical world should cause, at worst, nothing more than a modest increase in information costs. As long as buyers know what rights they have in the digital work they are buying—in other words, as long as they know whether they will be able to resell or rent the work—the market can properly operate. In contrast, as explained in Part V, if

²⁵² Similar concerns motivated Congress to enact Title I of the Digital Millennium Copyright Act, which includes controversial anticircumvention provisions. 17 U.S.C. § 1201.

²⁵³ See, e.g., Volokh, *supra* note 21, at 832–33.

²⁵⁴ Chilling digital distribution will likely reduce access and spillovers not just because one additional form of distribution is taken off the table. Digital distribution is a relatively cheap form of distribution, and therefore, as long as copyright exhaustion is illegal, it fosters the implementation of creative price-discrimination schemes, which can help serve buyers with low willingness to pay. See *supra* Part III.

²⁵⁵ See *supra* note 167 and accompanying text.

the buyers do not know their rights, the market will not operate efficiently. It is an unresolved empirical question to what extent buyers of digital copyrighted goods know whether they can transfer the items they purchase.²⁵⁶ It is likely that in some cases they know their rights quite well and in others less so.²⁵⁷ To the extent that buyers are unaware of their rights, a sensible policy might need to promote this understanding among buyers,²⁵⁸ but it should not open the floodgates by allowing unrestricted incentives-shuttering digital distribution.

C. Commercial Renting

The doctrine of copyright exhaustion provides that the owner of a copy of copyrighted work has the right to rent that copy, including commercially for profit.²⁵⁹ Therefore, even commercial libraries, such as Netflix DVDs and Redbox, are not required to secure a license to commercially rent copyrighted work. This aspect of copyright exhaustion is probably unique to American law.²⁶⁰

This Article suggests that commercial for-profit libraries should probably be required to purchase a separate renting license. The harm from allowing

²⁵⁶ Compare Perzanowski & Schultz, *supra* note 7, at 2069 (suggesting that individuals generally believe that they have a right to noncommercial home recording and to copy and back up work for personal use), and *id.* at 2079 (noting that consumers have a “reasonable expectation that when they buy something, they own it—and as a result they are able to use, alienate, or dispose of their property as they see fit.”), with Robinson, *supra* note 5, at 1491 (suggesting that the practice of restrictive licensing over digital work has been a standard market practice for over thirty years, and therefore buyers expect to have limited rights).

²⁵⁷ Intuitively, it seems that when a transfer is technically impossible, such as with Amazon’s Kindle eBook reader, or when buyers are savvy, they probably do not expect to be allowed to transfer copyrighted digital work. Less savvy buyers might be surprised to know that even when transfer is technically feasible, for example, when the purchased files do not include DRMs, it is legally prohibited. This intuition can be proved or disproved with an empirical study. I am not aware of such a study.

²⁵⁸ Effectively disclosing pertinent information to consumers might not be trivial. *See, e.g.*, Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647 (2011) (arguing that disclosure rarely substantially improves the decision-making process of laymen); *cf.* Ian Ayres & Alan Schwartz, *The No-Reading Problem in Consumer Contract Law*, 66 STAN. L. REV. 545 (2014) (claiming that the law should mandate disclosure of unfavorable terms that are beyond the buyers’ expectations). Analyzing the ways to promote buyers’ awareness and whether their benefits justify their costs is beyond the scope of this Article.

²⁵⁹ 17 U.S.C. § 109(a) (2012). The Copyright Act, however, provides that sound recordings and software may not be commercially rented with a license. *Id.* § 109(b). This limitation was added to the Copyright Act because Congress was concerned that renting those items would lead to massive piracy.

²⁶⁰ While I have not explored the laws of all countries, I am unaware of another jurisdiction that provides this right to commercial buyers. In the European Union, both renting and lending are exclusive rights of the copyright owner and thus require a license. Rental Directive, *supra* note 22; *see also*, GHOSH, *supra* note 33 (exploring copyright exhaustion in the United States, the European Union, Canada, China, India, Japan, and Brazil, and suggesting that only the United States allows commercial renting).

these commercial libraries to freely rent copyrighted goods is a decrease in incentives. Commercial for-profit libraries typically have a willingness to pay that is significantly higher than that of those who buy these goods for personal use. For example, Redbox usually rents each movie it owns about fifty times,²⁶¹ which means that it is probably willing to pay over \$75 for a copy of a typical movie.²⁶² Most individual buyers are willing to pay significantly less.²⁶³ Therefore, price discrimination is very lucrative when the copyright owner needs to sell copies to both commercial libraries and individuals. As explained in Part III, copyright exhaustion, which makes the separation between these buyers difficult, thus harms the income of the copyright owner and the incentives to create. At the same time, as also explained in Part III, the effects of copyright exhaustion on public access to copyrighted works are typically modest.

In addition, copyright exhaustion is expected to affect the pricing decisions of some copyright owners. Because of the significant difference between the willingness to pay of commercial renters and individual buyers, copyright exhaustion might not cause the seller to completely abandon price discrimination, but it will instead channel them to use price-discrimination schemes that are not vulnerable to unauthorized renting. However, as explained in Part IV.A, it is doubtful if those changes will improve social welfare in the short run or in the long run.

For example, movie studios use timing to discriminate among buyers. Under one version of this scheme, the initial price for movies for home viewing is set high, which allows only libraries to access the goods, followed by a low price, which provides access to individuals. The problem with this strategy, from a social perspective, is that individuals are denied access for several weeks or months, which is socially wasteful.²⁶⁴ Empirical work

²⁶¹ See *Redbox Automated Retail LLC v. Universal City Studios LLLP*, Civil No. 08-766 (RBK), 2009 WL 2588748 (D. Del. Aug. 17, 2009).

²⁶² Redbox currently charges \$1.50 for each night of DVD rental. See *Our Prices Are Increasing a Little*, REDBOX, <http://www.redbox.com/pricechange> (last visited Feb. 7, 2015). With fifty rentals per DVD (assuming that this number still holds) and even if each rental is only for one night, its income from renting a DVD is \$75. In addition, Redbox sells some of its old DVDs. The costs per DVD in running its services seems to be relatively low. Therefore, it seems reasonable to assume that Redbox is willing to pay more than \$75 per DVD it can rent.

²⁶³ A good, although far from perfect, indication to the individual buyers' willingness to pay is the price that is charged from them. DVDs, even shortly after their release, are typically sold for less than \$20. It is likely that if many buyers would be willing to pay close to \$75, prices would have been higher.

²⁶⁴ The most recent trend in this industry is to reverse the order of availability. DVDs are released first to individuals, while libraries (e.g., Netflix and Redbox) rent them out only a few weeks later. While the studios

suggests that total short-term surplus in the market for movies for home viewing in Europe, where libraries must secure a renting license, is higher than in the United States, where they do not.²⁶⁵ In the long run, this scheme is expected to also reduce the incentives to create.²⁶⁶

The need to reduce information costs, which can warrant copyright exhaustion in some contexts, cannot justify free, unauthorized commercial renting. Commercial, for-profit libraries are professional organizations that deal with renting on a large scale and therefore they are not expected to face significant information-costs problem.

Therefore, overall, the justifications for allowing the buyer of a copyrighted work to commercially rent it seem weak. The law should probably disallow it.

Public libraries might present a more difficult case because they provide access to typically weaker members of society and to researchers, who regularly produce significant spillovers and benefits that are sometimes not well represented by the consumers' willingness to pay.²⁶⁷ Therefore, it might make sense to treat public libraries differently. The existence of spillovers might justify sponsoring access to works through libraries by compensating copyright owners for public library lending, which is common in some countries, including those within the European Union.²⁶⁸

cannot legally prevent libraries from buying the DVDs designated for individuals and renting them out, the studios were able to contractually secure those arrangements by providing especially lucrative terms to the libraries. These lucrative terms decrease the income of the copyright owner while harming individuals who rent movies, who are now required to wait until the movie is available. In contrast, this new scheme eliminates the harm to individual buyers of DVDs, which are now able to purchase DVDs earlier.

²⁶⁵ Mortimer, *supra* note 133. One drawback of this research is that its data is based on practices that are more than a decade old. The 2004 study already suggested that new trends in home viewing might change the relative static efficiency of each regime. Since the publication of this study, this market went through additional significant changes. Therefore, it is possible that copyright exhaustion in the United States does not currently harm access to home viewing. However, there is little doubt that it harms incentives.

²⁶⁶ See *supra* note 146.

²⁶⁷ See FRISCHMANN, *supra* note 159, at 72; Cohen, *supra* note 99, at 1804–05.

²⁶⁸ See, e.g., Rental Directive, *supra* note 22, art. 5, at 63–64 (granting members of the European Union the ability to allow public lending if copyright owners are compensated); see also *supra* text accompanying notes 43–44. A full analysis of this scheme, which is beyond the scope of this Article, must take into account the source of this public financing and its related costs (e.g., the costs of the tax system).

D. Contracting Around Copyright Exhaustion

Should a contractual promise to refrain from reselling or lending copyrighted goods be enforced? The answer under current law is unclear.²⁶⁹ Some have argued that contracting around core doctrines in copyright law is preempted by the Copyright Act.²⁷⁰ In recent years, however, contracting around other core doctrines of copyright law has typically been enforced under contract law.²⁷¹

The analysis in previous Parts of this Article, and especially the discussion in Part V regarding the need to keep information costs low, can shed light on the complexity of this question. It could be argued that contracting around copyright exhaustion should not be problematic because contractual obligations require acceptance. Therefore, the argument goes, when a party—typically the buyer—accepts the contract, that party becomes aware of its terms and can properly evaluate them as part of the purchasing decision. If the contract forbids resale, the buyer will be willing to pay less, which will prevent the seller from offering such terms, unless it is efficient to do so. Under this approach, the copyright-exhaustion doctrine provides default rules, but in some cases the parties can choose to replace it with their own specific arrangements.

²⁶⁹ While the enforceability of promises that limit transferability under contract law is still an open question, in several well-known decisions courts have refused to find copyright infringement when the defendant ignored a limitation on transferability that was printed on the product. For example, in *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339, 341 (1908), a minimum price printed on the cover of a book was not enforced; in *UMG Recordings, Inc. v. Augusto*, 628 F.3d 1175, 1177–78 (9th Cir. 2011), a statement on the cover of a promotional CD that prohibited resale was not enforced; and in *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351, 1356 (2013), a notice printed in the textbooks that limited resale to certain countries was not enforced. Cf. Epstein, *supra* note 5, at 503–05 (criticizing the holding of *Augusto*); Katz, *supra* note 55, at 130–33 (same).

²⁷⁰ 17 U.S.C. § 301(a) (2012); see, e.g., RADIN, *supra* note 24, at 168–73; Benkler, *supra* note 151, at 429–35; Cohen, *supra* note 99, at 1812; Gordon, *supra* note 138, at 1378–86; Lemley, *supra* note 24, at 142–43; Michael J. Madison, *Legal-Ware: Contract and Copyright in the Digital Age*, 67 FORDHAM L. REV. 1025, 1051–52, 1130 (1998); David Nimmer, Elliot Brown & Gary N. Frischling, *The Metamorphosis of Contract into Expand*, 87 CALIF. L. REV. 17, 42–63 (1999); cf. Picker, *supra* note 17, at 295.

²⁷¹ See, e.g., *Montz v. Pilgrim Films & Television, Inc.*, 649 F.3d 975, 979–81 (9th Cir. 2011) (en banc) (enforcing a contract that creates legal rights in an idea which is not protected by copyright); *Bowers v. Baystate Techs., Inc.*, 320 F.3d 1317, 1323–26 (Fed. Cir. 2003) (enforcing a provision that contracted around the fair use defense); cf. *Ritchie v. Williams*, 395 F.3d 283, 287–88 (6th Cir. 2005) (holding a provision that restricts future transfer of copyright is unenforceable under contract law); *Canal+ Image UK Ltd. v. Lutvak*, 773 F. Supp. 2d 419, 441–44 (S.D.N.Y. 2011) (exploring the various approaches in the case law to the enforcement of contracts that create norms that are inconsistent with copyright law doctrines); Rub, *supra* note 17, at 258.

The problem with such an argument is that it ignores information costs. Idiosyncratic contractual obligations add information costs to the interactions between sellers and buyers.²⁷² Instead of relying on the default rules and the stable property law arrangements, buyers now need to spend resources on evaluating the legal attributions of the product they purchase. In fact, in modern markets most contractual obligations come in the form of long boilerplate provisions, written in a legal language, which are sometimes attached to the product itself.²⁷³ Understanding those terms requires buyers to spend considerable resources.²⁷⁴ Therefore, it is common for buyers to neither read nor be otherwise familiar²⁷⁵ with boilerplate provisions.²⁷⁶ This means that the terms of the contract, including the terms that govern the right to resell, cannot be taken into account in the buyers' purchasing decisions, which can result in inefficiency.²⁷⁷ In other words, if buyers cannot de facto take into account whether they will be allowed to resell a product, sellers might be tempted to prohibit resale even when it is inefficient to do so.²⁷⁸

²⁷² Note that this section discusses the creation of idiosyncratic contractual obligation and not idiosyncratic property rights. In other words, even if contracting around copyright exhaustion is allowed, those arrangements are enforced only in contract law and not against third parties. Idiosyncratic property arrangements create an even greater information costs problem. *See, e.g.*, Merrill & Smith, *supra* note 197, at 8 (“The existence of unusual property rights increases the cost of processing information about all property rights.”); Van Houweling, *supra* note 5, at 897–98.

²⁷³ These contracts that are attached to the good itself are called “viral” contracts because they are widely spread with the “host” product. *See* Margaret Jane Radin, *Humans, Computers, and Binding Commitment*, 75 IND. L.J. 1125, 1132 (2000). This attachment guarantees that everyone who uses the product accepts the terms of the contract. It does overcome the main limitation on contractual cause of action—the need to prove privity—and thus blurs the line between a contractual right and a property right.

²⁷⁴ The information costs that are attributed to standard-form contracting are high because those forms are complicated and because they vary from one to the other. This means that even if a buyer spends resources in reading and understanding a form contract, this will not reduce the information costs in future transactions. This is distinguishable from default rules, as even laymen can become familiar with them when they repeatedly operate in the marketplace. Once they are familiar with the default rules the transaction costs decreases. As mentioned above, *see supra* note 256 and accompanying text, it is unclear how well buyers are aware of the default rules regarding copyright exhaustion, although intuitively it seems that most of them expect to be able to resell a book they purchase in a bookstore but not a Kindle eBook, which is consistent with the default rules. *Cf.* Omri Ben-Shahar, *Regulation Through Boilerplate: An Apologia*, 112 MICH. L. REV. 883, 887–89 (2014) (reviewing RADIN, *supra* note 24) (comparing the complexity of form agreements to that of default rules).

²⁷⁵ *See generally* Ayres & Schwartz, *supra* note 258 (suggesting that it is better to ask whether buyers expect the terms of the contract to be so one-sided than to inquire if they read it).

²⁷⁶ RADIN, *supra* note 24, at 12–15; Van Houweling, *supra* note 5, at 933–34.

²⁷⁷ Guy A. Rub, *Market Regulation of Contractual Terms: A Sceptical View*, 54 CAN. BUS. L.J. 258, 263 (2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2506375.

²⁷⁸ The reality is, of course, more complex. Even if buyers do not read contracts, other mechanisms might limit the sellers' ability to provide harsh terms, such as the sellers' desire to preserve their reputation. Even if harsh terms are included in the contract, the seller might not enforce them because it is too difficult to do so

There is no easy solution to this problem.²⁷⁹ On one hand, it seems desirable to allow some sellers to create specific arrangements that are different from the default rules of copyright exhaustion. For example, record companies would like to distribute promotional CDs to radio stations, music critics, and reporters for free. The free distribution of those promotional CDs is thus important to the operation of the music industry. However, allowing the recipients of those promotional CDs to sell them cuts into the market share of the record companies and might discourage them from providing free CDs. Therefore, it seems socially desirable to allow record companies and radio stations to contractually agree to limit the transferability of promotional CDs.²⁸⁰ Similarly, it seems socially desirable to allow a software company and a student to enter into a contract for the sale of cheap, student-version software in which the student will promise not to transfer the product to nonstudents.²⁸¹

On the other hand, as explained above, those arrangements—especially if buried in long standard-form agreements—increase information costs, might be ignored by buyers, and can cause a market failure by being included in an agreement regardless of their inefficiency. While a full, detailed solution is beyond the scope of this Article, it seems that neither full enforcement of all contracts nor full preemption of all waivers of copyright exhaustion is efficient. Contracts that are the result of negotiation should typically be enforced because the parties are well aware of their rights and can take them into account. In such a situation, the parties are aware of their legal rights, and therefore information costs are less troubling. Boilerplate provisions, in contrast, should be subject to legal scrutiny to make sure that they are reasonable or fair.²⁸² Boilerplate provisions that the buyer is unaware of and

and because it creates reputational harm. See Lucian A. Bebchuk & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 MICH. L. REV. 827 (2006).

²⁷⁹ This problem is part of a bigger and especially complex challenge that contract law has been struggling with for decades: when, and to what extent, should boilerplate provisions be enforced. These provisions look like contractual obligations that were the result of an offer and acceptance but, on the other hand, because they are rarely read, they might not represent the parties' true assent. Obviously, this short section cannot solve the bigger challenge but only shed light on the considerations that should go into this analysis in the context of copyright exhaustion. For a comprehensive analysis, see generally RADIN, *supra* note 24.

²⁸⁰ Cf. *UMG Recordings Inc. v. Augusto*, 628 F.3d 1175 (9th Cir. 2011). In that case, the Ninth Circuit held that a statement on the cover of a free promotional CD, which prohibited resale, does not limit transferability. However, in that case there was no doubt that the statement on the cover of the CD was not a contract.

²⁸¹ Cf. *Adobe Sys. Inc. v. One Stop Micro, Inc.*, 84 F. Supp. 2d 1086 (N.D. Cal. 2000) (discussing the legality of reselling students' version software to nonstudents under copyright law).

²⁸² In *Bowers v. Baystate Technologies, Inc.*, Judge Dyk, dissenting in part, stated that contractual limitations that are inconsistent with the Copyright Act should be enforced only if they are the result of

that are not reasonable or fair should probably not be fully enforced.²⁸³ This scheme may also incentivize sellers to make sure that buyers are aware of contractual restrictions that are inconsistent with their reasonable expectations.²⁸⁴

E. Nonownership Interests: Licensees Versus Owners

The discussion in section D can promote a more careful analysis of one of the most complex questions regarding the scope of copyright exhaustion: what norms should govern a transfer of interest that is allegedly not a sale.

The Copyright Act states that copyright exhaustion shields only “the owner of a particular copy.”²⁸⁵ Therefore, possessors of copies who are not owners are not entitled to this defense²⁸⁶ and must accept the copyright owner’s control over the distribution of these copies.²⁸⁷ The most important category of those who possess a copy without owning it are mere “licensees.”²⁸⁸

negotiation and not if they are part of a standard-form agreement. 320 F.3d 1317, 1335–38 (Fed. Cir. 2003) (Dyk, J., concurring in part, dissenting in part). This policy is far reaching and seems undesirable. As suggested in this section, in some cases some standard-form agreements that contract around copyright law are efficient and should probably be enforced. Moreover, Judge Dyk’s approach is inconsistent with the regulation of boilerplate provisions in other areas of the law. Courts routinely enforce contractual provisions that limit the rights of the buyers, even if those limitations are included in a standard-form agreement. *See, e.g.*, AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011) (holding that parties can waive their right to class action, including class action arbitration, in a standard-form agreement); *see also* Robinson, *supra* note 5, at 1475–76 (suggesting that the problem of enforcing shrinkwrap licenses “implicates practically the entire realm of modern marketing”).

²⁸³ This framework for the enforcement of boilerplate provisions is similar, in many respects, to the rules of contract unconscionability. Unconscionability sometimes bars the enforcement of standard-form agreements to prevent “oppression and unfair surprise.” U.C.C. § 2-302 cmt. 1 (2014). It is important to acknowledge that while the abstract principles of legal scrutiny might be easily articulated, forming a detailed legal test to apply them, which is beyond the scope of this Article, might not be trivial. *See supra* note 279.

²⁸⁴ *Cf.* Ayres & Schwartz, *supra* note 258 (suggesting that not enforcing terms in standard-form agreements that are surprisingly detrimental to buyers will incentivize sellers to effectively disclose those terms).

²⁸⁵ 17 U.S.C. § 109(a) (2012) (limiting copyright exhaustion to “the owner of a particular copy or phonorecord lawfully made under this title”).

²⁸⁶ *Id.* § 109(d) (“The privileges [of copyright exhaustion] do not . . . extend to any person who has acquired possession of the copy or phonorecord from the copyright owner . . . without acquiring ownership of it.”).

²⁸⁷ *Id.* § 106(3).

²⁸⁸ The term “licensee,” in this context, while commonly used, is confusing and likely wrong. A license is a promise not to enforce a right, typically a property right. In the context of copyright law, it is typically a promise not to enforce one or several of the exclusive rights over the intangible nature of the work. Thus, a copyright license that allows a publisher to make copies of a copyrighted book means that notwithstanding the exclusive right of reproduction, the licensee (i.e., the publisher) cannot be sued for copyright infringement for

Therefore, it is crucial to distinguish owners from licensees. The formers get to control the distribution of copies of copyrighted works pursuant to the principles of copyright exhaustion, while the latter do not.²⁸⁹ Moreover, as discussed below, this distinction is crucial not only in determining the rights of the parties to the transaction but those of third parties as well. Once a transaction is not a sale but just a license, copyright exhaustion is unavailable to the licensee and any future possessor of the copyright goods. In other words, once a transaction over a copyrighted good is not a sale, any future possessor along the chain of possession will be liable for copyright infringement for any kind distributing the good.²⁹⁰

There are two main approaches for distinguishing owners from licensees. *Vernor v. Autodesk, Inc.*, the leading case in the Ninth Circuit on the topic, states three factors that need to be considered:

[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.²⁹¹

usage that is consistent with the license. A copyright licensee may or may not be an owner of the physical copies.

In contrast, in the context of copyright exhaustion, the identity of the owner of the exclusive rights, as well as the existence of any license with respect to these exclusive rights, is almost irrelevant. The application of copyright exhaustion depends on the personal property interest in the tangible copy. Thus, in this context, the term "license" or "mere license" describes the relationship between the possessor and the tangible copy. It is a form of possessory interest that is weaker than ownership but not identical to one of the familiar nonownership possessory interests (such as "bailment" or "rent"). It is difficult to describe this possessory interest in terms of "a promise not to sue." Because this term, while confusing, is commonly used in the case law, I will use it here as well. See Brian W. Carver, *Why License Agreements Do Not Control Copy Ownership: First Sales and Essential Copies*, 25 BERKELEY TECH. L.J. 1887, 1931–37 (2010) (criticizing the misuse of the term "licensee" in this context); see also Asay, *supra* note 21, at 18–19 (same).

²⁸⁹ There are additional rights that the Copyright Act dedicates just to owners. The most important of these, except for copyright exhaustion, is probably the "essential step" defense, 17 U.S.C. § 117(a)(1), which provides that owners of software can copy it to the computer's memory. Because such a copy of a software is created automatically every time it is used, nonowner possessors need a license to use a software, and their usage can be limited by the terms of such a license. *Jacobsen v. Katzer*, 535 F.3d 1373, 1380–82 (Fed. Cir. 2008).

²⁹⁰ This makes the issues discussed in this section somewhat distinctive from the issues discussed in section D. Section D explores whether the parties can write a contract that would limit copyright exhaustion and enforce it under contract law. For example, can a seller sue, *under contract law*, a buyer who promised not to resell a copyrighted product and yet does it? This section asks when should a transaction not be considered a sale, which allows the seller (who is not really a seller but a licensor) to sue the buyer (who is actually just a licensee) or any future possessor *under copyright law* for every transfer of possession in the copyrighted good.

²⁹¹ 621 F.3d 1102, 1111 (9th Cir. 2010).

The most crucial aspect in this test and the way in which the *Vernor* court applied it, is that it focuses exclusively on the four corners of the contract—a standard-form agreement drafted by the seller—in order to determine the nature of the buyer’s possessory interest. In that case, the owner of copyright in a computer program was able to characterize a transaction as a mere license and thus to prevent the resale of the physical objects (CD-ROMs) in which the program was embodied, although that copyright owner originally placed those objects in the stream of commerce.²⁹²

Other courts have adopted a different test to distinguish owners from mere licensees. For example, the leading case in the Second Circuit shows more deference to the buyers’ expectation. The Second Circuit stated as follows:

[I]t seems anomalous for a user whose degree of ownership of a copy is so complete that he may lawfully use it and keep it forever, or if so disposed, throw it in the trash, to be nonetheless [a licensee and therefore] unauthorized to fix it when it develops a bug, or to make an archival copy as backup security.²⁹³

The Second Circuit therefore applies an “economic realities” test, which looks at the actual economic nature of the transaction in order to explore whether it is sensible to consider it a sale.²⁹⁴ Therefore, if the transaction looks like a sale, the Second Circuit will treat it as such, even if the standard-form agreement characterizes it as a mere license.

The approach advocated by this Article, which suggests that the law should balance various factors—and in particular the need to keep incentives high and information costs low—in determining the scope of copyright exhaustion, supports the “economic realities” approach of the Second Circuit.

The “four corners” approach of the Ninth Circuit seems inconsistent with the need to keep information costs at bay. The Ninth Circuit is *de facto* providing copyright owners with a plan of attack—magic words—that allow

²⁹² *Id.* at 1103–06.

²⁹³ *Krause v. Titleserv, Inc.*, 402 F.3d 119, 123 (2d Cir. 2005). This case did not directly address copyright exhaustion but the related “essential step” defense. *See supra* note 289. However, the tests for separating owners from licensees under the copyright exhaustion doctrine and under the “essential step” defense are the same.

²⁹⁴ *Krause*, 402 F.3d at 124 (“[C]ourts should inquire into whether the party exercises sufficient incidents of ownership over a copy . . .”). This test did not originate in this case. In fact, prior to *Vernor*, several district courts in California and, on some occasions, the Ninth Circuit itself, used it. *See Carver, supra* note 288, at 1915–20. Other federal courts of appeals use a somewhat similar test. On the development of the various approaches in different courts, *see id.* at 1898–1925.

them to contract around copyright exhaustion. As section D explains, buyers do not read standard-form agreements, nor should they. Holding that a transaction that looks like a sale (e.g., one that involves a single payment for which an unlimited period of possession is granted) is not a sale, only because of unread language in a standard-form agreement, frustrates the reasonable expectation of the buyers. As explained in section D, this practice is problematic from an information costs perspective and it can lead to inefficient transactions in the marketplace.

In contrast, the focus of the Second Circuit on the buyers' expectation is consistent with the position this Article takes regarding the need to reduce information costs. There are cases in which the possessor should not be considered an owner and, therefore, should not be entitled to the copyright exhaustion defense. For example, when the owner lends a copy to a possessor, or when the parties agree that the possessor will hold the copy for a limited time, subject to periodic payments, the possessor should not be considered an owner. Because buyers typically know about the economics of their transactions (e.g., whether they will be required to make periodic payments or not), enforcing legal limitations on their rights when the economics of the transaction does not treat them as owners is consistent with their expectations and is efficient. In other cases, when the transaction looks like a traditional sale, copyright exhaustion should be applied.

The superiority of the “economic realities” test over the “four corners” test is even clearer when the interests of third parties are taken into account. As explained above, when a transaction is a mere license over a certain copy (and not a sale of that copy), the rights of third parties are restricted because all future possessors of such a copy will not be considered owners. Therefore, those possessors, whether or not they even had a chance to read the original contract, would not be legally able to distribute the copy they paid for.

The Copyright Act does not include any effective mechanism that protects the interests of future buyers in this situation,²⁹⁵ and therefore it might cause third parties to spend resources on validating their rights. As explained in

²⁹⁵ When an agreement between two parties (e.g., a buyer and a seller) affects the rights of third parties (e.g., future buyers), the law needs to deal with a notice problem: the need to inform these third parties of their rights. This is a significant concern in the area of servitudes. *See supra* notes 215–16 and accompanying text; *see also* Van Houweling, *supra* note 5, at 893–99. There are various ways that the law can mitigate this problem including registration, *see supra* note 214, or the doctrine of bona fide purchaser without notice, which, in some cases, grants such a purchaser clean title, *see, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 342 (1981). However, currently, the Copyright Act does not include any such mechanism.

Part V, this will inefficiently raise information costs, which is a form of waste and might create a chilling effect on the market. Therefore, current law should be interpreted in a way that minimizes the harm to third parties. The Ninth Circuit's four corners test seems especially inconsistent with this interpretive approach because it requires any buyer to examine the agreement between the copyright owner and the first buyer as well as any subsequent agreement between previous buyers in order to make sure that all these transactions were characterized as sales. The Second Circuit's economic realities approach better protects third parties who can verify this reality more easily.²⁹⁶

CONCLUSION

In 1897, Oliver Wendell Holmes, Jr. stated that it "is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV" and noted that it "it is still more revolting if the grounds upon which it was laid down have vanished long since, and the rule simply persists from blind imitation of the past."²⁹⁷ Several years later, in 1908, the Supreme Court, now with Justice Holmes among its ranks, created the copyright-exhaustion doctrine.²⁹⁸

²⁹⁶ Notwithstanding these advantages, in some cases the Second Circuit's economic-realities approach can be burdensome on the copyright owner. Consider, for example, the distribution of cheap, student-version software that limits the transferability of these copies to nonstudents. There seems to be real social value in enforcing such a restriction. *See supra* note 281 and accompanying text. The seller-copyright owner can include such restrictive language in the contract and can inform the students-buyers of this limitation and thus, at least under the test proposed in section D, will have a cause of action in contract law if a buyer later transfers the software to a nonstudent. But this contractual cause of action is ineffective against third parties that buy the software without accepting the contract. For example, in *Adobe Systems Inc. v. One Stop Micro, Inc.*, 84 F. Supp. 2d 1086 (N.D. Cal. 2000), which deals with a company that regularly purchased student-version software CDs and resold them to nonstudents, the plaintiff had no contractual cause of action. In that case, the court classified the transaction (which looked like a sale) as a mere license, which allowed the plaintiff to sue the defendant for copyright infringement.

Nevertheless, in situations like this, copyright owners can have other causes of action against third parties, even without classifying the transaction as a mere license. For example, the copyright owner can sue for intentional tortious interference with contractual relations because the third party intentionally encouraged the students to breach their contract with the copyright owner. *See* RESTATEMENT (SECOND) OF TORTS § 766 (1979). The main advantage of the tortious interference cause of action over the copyright cause of action is that it is more attentive to the problem of information costs because it requires the defendant to be aware of the contractual limitation. While this and other possible solutions (e.g., limiting future distribution using a DRM) might not be a perfect solution, as long as the Copyright Act does not include any other reasonable mechanisms that allow buyers to reasonably verify their legal rights in items they purchase or to get a clean title, the "economic reality" approach seems like the lesser of two evils.

²⁹⁷ Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 469 (1897).

²⁹⁸ *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339 (1908).

The world has changed in the century that has passed since that decision. The markets for information goods have been revolutionized. Our understanding of the forces that drive and shape markets, including markets for information goods, has been developed and modernized as well as the legal norms that police these markets. Therefore, it is only natural that the copyright-exhaustion doctrine, which was originally motivated, to a large degree, by the early-twentieth-century understanding of the early-twentieth-century markets, will need to be reexamined and rebalanced today.

This Article suggests that while the original rationales for copyright exhaustion are weak justifications nowadays, the doctrine serves an important social function by reducing information costs. Including the right to transfer copyrighted goods within the bundle of rights of buyers sets reasonably clear borders to the property rights of those buyers and thus helps diminish information costs.

Copyright exhaustion also has costs. The main harm of the doctrine is a possible reduction in the incentives to create and an undesirable, regressive distributive effect. Therefore, on one hand, the doctrine should be interpreted broadly where information costs are high and the reduction in incentives, as well as the regressive distributive effect, is moderate. On the other hand, it should be interpreted narrowly when information costs are low and the reduction in incentives, as well as the regressive distributive effect, is significant.

This Article shows how those considerations can shape the scope of the copyright-exhaustion doctrine and help it tackle the major questions it faces in recent years. The Article suggests that copyright exhaustion should not prevent the copyright owner from exercising control over the commercial importation of copyrighted goods or over the digital distribution of works. However, contracting around the doctrine should be subject to legal scrutiny and copyright owners should not be allowed to circumvent the norms of exhaustion just by including “magic words” that limit transferability and that categorized buyers as mere licensees in their standard-form agreements.

Implementing the balanced approach advocated by this Article should allow the copyright-exhaustion doctrine to better meet the challenges of the twenty-first century.