Exhaustion of Intellectual Property Rights: A Non–Tariff Barrier to International Trade?

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I. Introduction

As technological developments continue, the level of investment in research and development forces investors to expand into international markets in order to recoup their costs. The level of intellectual property protection granted is a major concern to investors in determining where and how to invest, in order to ensure that the benefit of the products they have developed is reaped by themselves and not unjustly by third parties, who have not incurred any of the costs. Consequently, the link between the protection of intellectual property rights (IPRs) and international trade has become highly visible.

Obtaining the right level of intellectual property (IP) protection is a delicate issue. Whilst a lack of protection may be a deterrent for the proprietors of IPRs who are willing to invest in foreign markets, excessive protection may lead to an abusive exercise of the exclusive rights granted under IP legislation.

Unlimited protection granted to IPR owners may tempt them to use their exclusive rights to control the sale and distribution of their products in a way which intervenes with free trade. One of the principles that has evolved in intellectual property law to prevent such an outcome is the *principle of exhaustion of IPRs*. By limiting the exclusive right of sale of IPR owners to the first sale and distribution of the product, this principle tries to find a balance between IPR protection and free trade. In many legal systems, this principle has a "territorial" characteristic which leads to the prohibition of the practice of parallel importation and thereby restricts international trade.[1]

Under the principle of sovereign rights, each state can legislate on matters of intellectual property rights, as it sees fit. However, there are many multilateral conventions and organisations that aim at establishing international standards of intellectual property law. At the same time, negotiations have been held in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) on the matter of Trade Related Aspects of Intellectual Property (TRIPS) and the agreement reached has

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1 It should be emphasized that parallel importation is trade in lawfully produced products, not pirated or counterfeit goods.

become a part of the Agreement Establishing the World Trade Organisation which was signed at the Marrakesh Ministerial Meeting in April 1994.

In the face of the international developments, should the principle of territorial exhaustion of IPRs continue to exist, thereby constituting a barrier to free trade?

The purpose of this paper is to discuss this question. In the first part, the concepts of "exhaustion," "territoriality" and "parallel importation" will be examined. In the second part, the evaluation of the exhaustion principle as applied under the law of the European Communities (EC law), the law of the United States (US law) and GATT law will be reviewed with special emphasis on EC law. The final section will discuss the arguments for and against the territoriality of the exhaustion principle.[2]

II. Concepts

From the end of the 19th century, IP legislation has granted broad rights to the owners of patents, copyrights and trade marks. Relying on their exclusive rights, owners have tried to control the sale and distribution of their products in a way which limited the freedom of the buyers to further sell and distribute the products protected by IP legislation. The conflict between the producers, who did not want to make concessions in their exclusive rights, and other merchants who wanted to trade such products, was resolved in the courts through the establishment of the theory of exhaustion of IPRs.[3] First, the US courts and subsequently, German courts held that the ownership of intellectual property rights did not grant the right to prescribe the conditions under which products could be traded after the owner exercised his exclusive right to produce and market the product for the first time.[4]

The purpose of the *principle of exhaustion* is to find a balance between the protection of free trade and the protection of intellectual property. The principle also embodies the resolution of a conflict between the safeguarding of the public interest and the exploitation of private property. According to the principle, once a product that is protected by a copyright, patent or trademark, has been marketed by the title-holder or with his consent within the domestic market, purchasers can then freely trade the good within the same market without being interrupted by the title-holder. This is because the owner's rights of sale and distribution of the product have been "exhausted."

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2 Hereinafter "territorial exhaustion."

3 Hereinafter the "principle of exhaustion."

4 Yusuf A., Moncayo van Hase A., *Intellectual Property Protection and International Trade, Exhaustion of Rights Revisited*, World Competition 1992: 1 pp. 115-132, at 117.

The development of the exhaustion of rights theory has followed different paths in the common law and civil law jurisdictions. While the latter favours the principle of exhaustion of rights, the common law jurisdictions tend to employ the *implied licence theory*. According to this theory, the owner of an intellectual property may, upon the sale of goods, impose restrictions on the further use, sale and distribution of the product. Unless he does so, the sale of goods carries with it an implied licence that the purchaser may use the goods for reasonable contemplated purposes. Therefore, under this theory, the exhaustion of the exclusive rights of the title-holder is not automatic, but depends on his discretion.[5] Exhaustion is implied in the absence of an express prohibition by the title-holder. Under the exhaustion of rights principle, however, the title-holder cannot restrain the further sale and distribution of the product once it is sold by his will.

Two important elements involved in the exhaustion principle have to be emphasized at this stage. The first one is the fact that only the marketing, sale and distribution rights granted under IP protection can be exhausted after the first sale within the domestic market. Others, such as reproduction, lending or public performance rights remain with the IPR holder and are not exhausted after the first consented sale.

The second one is the territorial characteristic of exhaustion as applied in many legal systems. *Territorial exhaustion* implies that the exclusive right of first sale of the title-holder can only be exhausted within the territory where the protection is granted. The fact that the title holder may have voluntarily sold his product in a third country does not affect the exclusivity of his right of first sale within the domestic market.

IPRs are granted by states for their own territories, and are thus "independent" of one another. This means that, to ensure the protection of a product within one territory, the owner must have, not only an exclusive right of first sale, but also an exclusive right of importation into the relevant territory.

The importation into the domestic market of products that have been marketed in a third country by or with the consent of the title holder is called *parallel importation*. Under the principle of territorial exhaustion, the title holder can at any time, even after the exhaustion of his distribution rights within the domestic market, prevent the parallel importation of original goods that have been marketed by him, or with his consent, in a third country. Clearly, this allows the title holder to divide his markets and insulate them from the competition that would otherwise stem from the existence of numerous licenced or authorised dealers of the same product throughout the world.

In some developed countries such as the United States, there is a tendency to replace territorial exhaustion by *international exhaustion*, whereby the exclusive right of first sale of the titleholder is exhausted for all territories after the first voluntary marketing of the product, regardless of where this takes place. Parallel importation is thereby

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5 *Ibid*, at 118.

permitted, as there is no specific territory into which there can be a right of exclusive importation.

In some other countries, territorial exhaustion has been replaced by *regional exhaustion*, whereby the territories of a number of countries are treated as one and rights are exhausted within that region. Although this can be considered as an improvement towards more liberal trade, this type of exhaustion in fact only benefits the countries which are included in that region and continues to legitimise barriers towards third countries. The system of exhaustion applied within the EC constitutes a good example of regional exhaustion.

III. The Principle of Exhaustion of IPRs As Applied in Different Legal Systems

In this section, it will be examined how the principle of exhaustion has evolved in different legal systems; namely under EC law, US law and in the GATT.

III. 1 EC Law

The Treaty Establishing the European Economic Community, (EEC Treaty) does not contain any direct provisions on the exhaustion principle. However, it contains three articles[6] that are relevant to the issue of exhaustion. A long line of case law of the European Court of Justice (ECJ) has come about as a result of the attempts to reconcile these three different articles. This has led to the ECJ developing a regional application of the exhaustion principle.

Article 222 prevents the EEC Treaty from interfering with the national systems of property ownership. Being an intangible form of property, industrial and commercial property (or using a broader term, intellectual property) is covered under the application of Article 222. Therefore, the ownership of intellectual property, as it exists under the laws of the Member States of the European Communities is recognised by Community law.

The second article relevant to the issue is Article 30, which provides for the free movement of goods within the EC. According to this article, quantitative restrictions on imports and "all measures having equivalent effect" shall be prohibited in trade between the Member States. Although this article is not directly related to intellectual property, the way intellectual property rights are used or exercised may constitute "a measure having an equivalent effect" to a quantitative restriction on imports and may come under the prohibition of Article 30.

The third article to be mentioned is Article 36, which lists the exceptions to Article 30. According to Article 36, Member States are permitted to restrict intra-Community trade in order to protect industrial or commercial property, provided that such restrictions do not

6 Articles 30, 36, 222 EEC.

"constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States."

Reading all three articles together, it can be concluded that although the existence of national intellectual property rights is recognised by Community law (Art. 222), the way they are exercised may infringe Article 30 but nevertheless be justified under Article 36. This is exactly as the ECJ ruled in *Deutsche Grammophon v. Metro*:

> "(...) although the Treaty does not affect the *existence of rights* recognised by the legislation of a Member State with regard to industrial and commercial property, the *exercise of such rights may* nevertheless fall within the prohibitions laid down by the Treaty."[7] (emphasis added)

The Court of Justice thus established the first principle leading to a finer reconciliation of the above-mentioned articles together with the protection of IPRs and the protection of free trade. After drawing a distinctive line between the existence and exercise of rights, the Court had to establish a standpoint in Community law regarding the extent to which the existing rights could be exercised without falling within the prohibitions of Article 30. The criterion that the Court devised for this purpose was that of the "specific subject matter." In *Deutsche Grammophon v. Metro*, the Court held that:

> "Although it permits prohibitions or restrictions on the free movement of products, which are justified for the purpose of protecting industrial and commercial property, Article 36 only admits derogations from that freedom to the extent to which they are justified for the purpose of safeguarding rights which constitute the *specific subject matter* of such property."[8] (emphasis added)

In a later case, the Court defined the specific subject matter of a patent. In *Centrafarm v. Sterling Drug* the Court held that:

> "In relation to patents, the specific subject matter of the industrial property is the guarantee that the patentee, to reward the creative effort of the inventor, has the exclusive right to use an invention with a view to manufacturing industrial products and putting them into circulation for the first time, either directly or by the grant of licences to third parties, as well as the right to oppose infringements."[9]

Despite what the term "specific subject matter" suggests, the definition does not try to describe what a patent (or a type of industrial property) is, or what it should cover. It is clear that the Court did not

7 Case 78/70 *Deutsche Grammophon v. Metro* (1971) ECR 487 at para. 11.
8 *Ibid*, at no. 11.
9 Case 15/74 *Centrafarm v. Sterling Drug* (1974) ECR 1147 at no. 9

attempt to specify what a patent is.[10] Instead, it interpreted an aspect of intellectual property rights for the purpose of applying Article 36. Accordingly, the specific subject matter of a patent is the guarantee provided for the exclusivity of the right to first manufacture, market and distribute the protected product. Such a definition could be applied to most kinds of intellectual property, as it does not involve the contents of a specific type of IP, but analyses the extent of rights which attach to the IP. The same approach was taken by the Court in defining the specific subject matter of a trade mark, where the important issues in the definition were "the guarantee" of the "exclusivity" of "putting into circulation" products protected, "for the first time."[11] Both definitions included other factors, such as the intent to reward the creative effort of the inventor (in the case of patents) and the intent to provide protection against imitators (in the case of trade marks). However, it is apparent that such factors do not constitute the essence of the "specific subject matter" in a definition aimed at interpreting Article 36.

In its attempt to clarify the extent to which derogations under Article 36 are allowed, the Court has thus established the rule that any derogations from the principle of the free movement of goods must have the purpose of guaranteeing the exclusivity of the right to first market. This is a positive criterion, in the sense that it states what the derogations should accomplish and in what circumstances they can be justified under Art. 36. Besides this criterion, the Court has also devised a negative criterion in the sense that it states what results the derogations should not lead to and in what circumstances they will not be justified. The criterion which limits the freedom of the Member States to protect IPRs is explained in a case regarding copyrights:

> "If a right related to copyright is relied upon to prevent the marketing in a Member State of products distributed by the holder of the right or with his consent on the territory of another Member State on the sole ground that such distribution did not take place on the national territory, such a prohibition, which would legitimise the isolation of national markets, would be repugnant to the *essential purpose of the Treaty, which is to unite national markets into a single market*.
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> That purpose could not be attained if, under the various legal systems of the Member States, nationals of those States were able to partition the market and bring about arbitrary discrimination or disguised restrictions on trade between Member States."[12] (emphasis added)

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10 The Court did not have the power to define a "patent", as this is clearly a matter of national competence, by virtue of Art. 222 EEC. What a patent is, is thus a matter for national legislation, which will be influenced by international conventions, principally the Paris Convention and the European Patent Convention.

11 Case 16/74 *Centrafarm v. Winthrop* (1974) ECR 1183 at para. 8.

12 Case 78/70 *supra*, note 7 at para. 12.

The reasoning used in this judgement to delimit the freedom of Member States to invoke national IP legislation under Article 36 is connected to the attainment of the "essential purpose of the Treaty," which is to create a single internal market. Accordingly, Member States cannot use national IP laws in a way that would result in the partitioning of the internal market and the creation of barriers to intra-EC trade.

Consequently, by providing for a positive boundary (aiming at the protection of the specific subject matter) and a negative boundary (avoiding the partitioning of the markets), the Court has limited the use of the exceptions brought under Article 36. While the former criterion is used to justify the use of national IPRs, the latter is used to limit their use. The Court subsequently clarified how these criteria should be applied. In Keurkoop v. Nancy Kean Gifts the Court ruled that:

> "Article 36 is intended to emphasize that the reconciliation between the requirements of the free movement of goods and the respect to which industrial and commercial property rights are entitled must be achieved in such a way that protection is ensured for the *legitimate exercise*, in the form of prohibitions on imports which are *"justified"* within the meaning of that article, of the rights conferred by national legislation, but is refused, on the other hand, in respect of any *improper exercise* of the same rights which is of such a nature as to maintain or establish artificial partitions within the common market."[13] (emphasis added)

According to this judgement, to determine if the manner in which IPRs are used falls within Article 36, it should be examined whether the intellectual property rights conferred by the national legislation are exercised in a legitimate manner or not. Some authors have criticised the specific subject matter criterion for being too vague and have deduced from this judgement that the jurisdiction of the Court has moved in the direction of "a simple demarcation between legitimate and improper exercise of industrial property rights" whereby legitimate exercise is defined pursuant to national law and improper use is defined pursuant to Community law.[14] As previously explained, with the specific subject matter criterion, the Court has simply attempted to provide a general definition of the extent to which national IPR protection can be justified under Article 36. Even under the system of examining the legitimate/improper use of IPRs, this criterion will be used to justify the use of national IP legislation as "legitimate." National laws may only define intellectual property rights under their systems (as they did before) whilst it is for the ECJ to assess the legitimacy of the use of such rights under Community law. Nevertheless, although the Court may continue to use this criterion, it might give more emphasis to the second

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13 Case 144/81 *Keurkoop BV v. Nancy Kean Gifts BV* (1982) ECR 2853 at para. 24.

14 F. K. Beier, *Industrial Property and the Free Movement of Goods in the Internal European Market*, IIC Vol. 21 No. 2/1990, pp. 131-160 at p. 149.

criterion used to delimit the use of national IPRs. In other words, the limitation of avoiding the establishment of artificial partitions within the common market may be used more frequently in future cases.

While aiming to reconcile "the requirements of the free movement of goods and the respect to which industrial and commercial property rights are entitled," the Court arrived at an important conclusion regarding the territorial exhaustion of IPRs:

> "The proprietor of an industrial or commercial property right protected by the legislation of a Member State may not rely on that legislation in order to oppose the importation of a product which has lawfully been marketed in another Member State by, or with the consent of, the proprietor of the right himself or a person legally or economically dependent on him."[15]

In other words, the proprietor of an IPR may not rely on national legislation to prevent parallel imports within the EC.[16] This means that the Court has ruled out the use of national territorial exhaustion of IPRs within the EC. This is based on the grounds that territorial exhaustion gives title holders the right to prevent parallel imports and therefore grants them the ability to divide and isolate markets. Such an act would be totally contrary to the "essential purpose of the Treaty" which is to unite national markets into a single market. According to the Court, the establishment of the single market has precedence over the protection of national IPRs and the freedom of movement of goods has priority over the freedom of exploitation of personal property. However, the Court does not follow the same principle when the issue is the freedom of movement of goods outside the EC rather than within the EC.

It has been held that although title holders cannot prevent parallel importation from other Member States, they can prevent parallel importation from third countries. The Court held in *EMI Records v. CBS UK*, a case involving trade marks, that:

> "The exercise of a trade-mark right in order to prevent the marketing of products coming from a third country under an identical mark, even if this constitutes a measure having an effect equivalent to a quantitative restriction, does not affect the free movement of goods between Member States and thus does not come under the prohibitions set out in Article 30 et seq. of the Treaty."[17]

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15 Case 144/81 *supra* note 13 at para.25.

16 There may be an exception to this rule. In a recent preliminary decision of the Patent's Country Court in the UK, it was held that Article 47 of the Spanish Instrument of Accession to the Treaty of Rome allowed the prevention of parallel imports from Spain to UK until 1993. See Jones, J. *Exhaustion of Rights: Pharmaceuticals Marketed in Spain – A Wellcome Exception?* (1993) 3 EIPR 107.

17 Case 51/75 *EMI Records Limited v. CBS UK Limited* (1976) ECR 840.

Although it is possible to sense an air of protectionism in this judgement, this is due to the fact that the Court based its judgement on Articles 30 and 36 only, which apply solely to trade between Member States. Nevertheless, even in cases where the issue was the prevention of parallel importation into the Community from a country which had signed a free trade agreement with the Community, the Court did not interpret certain articles in the free trade agreement in the way it interprets Articles 30 and 36. In *Polydor v Harlequin*[18], the Court ruled that the aim of the EEC Treaty and that of the Free Trade Agreement (FTA) between the EC and Portugal were different since the FTA did not intend a unification of the markets as strongly as the EEC Treaty. Therefore, even though the articles in the FTA relating to the prohibition of quantitative restrictions to trade and the protection of IP were very similar to Articles 30 and 36, they need not be interpreted in the same way. The Court thus concluded that parallel importation of products legally produced in Portugal, into the EC could be impeded despite the existence of an FTA between Portugal and the EC. This reasoning is due to the fact that the main concern of the Court in prohibiting the prevention of parallel importation within the Community is to protect the integrity of the single market which is a goal distinct from the protection of free trade. Therefore, it would be fair to say that the judgement of the Court in *Polydor v. Harlequin* has a protectionist tendency.

It is understood that neither territorial exhaustion nor international exhaustion is applied under Community law. The principle that applies in EC law is regional exhaustion, where the territories of a number of states are treated as one. Indeed the Court has ruled that even the differences between national laws regarding distribution rights or royalties would not prevent the treatment of different markets as one and would not justify the maintenance or introduction by a Member State of measures which are incompatible with the rules concerning the free movement of goods.[19] As proprietors of IPRs are free to choose where to market their products within the Community, they should calculate the different consequences that may result from the disparaties in national laws. Even the fact that protection may not exist for a certain type of intellectual property in a Member State does not change this principle. It has been contested in *Merck v. Stephar* that lack of protection of patents in a certain Member State prevents the inventor from getting the reward that patent protection is aimed to provide. The Court held, however, that patent protection enables the inventor to place his product on the market for the first time with a view to obtaining the reward deserved, without actually guaranteeing that a reward will be obtained under all circumstances.[20] This shows the determination of the Court to ensure the freedom of movement of goods before ensuring individual reward from

18 Case 270/80 *Polydor v. Harlequin Record Shops* (1982) ECR 329.

19 Cases 55 & 57/80 *Musik-Vertrieb Membran v. GEMA* (1981) ECR 147.

20 Case 187/80 *Merck & Co Inc. v. Stephar BV and Petrus Stephanus Exler* (1981) ECR 2063 at para.10

IP protection. In fact, the Court aims at guaranteeing the existence of circumstances where title holders will be free to exploit the protection provided for IPRs in the best possible way.

One decisive element for the application of the regional exhaustion theory is the existence of the consent of the title holder in the marketing of his product. In this context, consent is the voluntary agreement of the title holder to the manufacturing and marketing of his product. In some cases, the manufacturing of a good which is protected by IPRs may be authorised by law in the absence of such consent. This is called "compulsory licensing." Compulsory licensing is used to prevent the abuse of the monopolistic right of manufacturing of a product protected by IPRs. For example, if a product protected by a patent is neither produced nor licensed to be produced by the patent-holder for a certain period of time (usually two or three years) and if the product is necessary for the protection of health or if there is domestic demand for such product, then the government may authorise third parties to manufacture such a product without the consent of the patent holder.[21]

According to the judgement in *Pharmon BV v. Hoechst AG*, the compulsory licensing of a patent does not contain the free will of the title holder and therefore cannot be construed as his consent.[22] Under these circumstances, such licensing can only be valid in the territory of the Member State that grants it and does not give the right of importation to the compulsory licensee.

Moreover, different States may grant different terms of protection to IPRs and whilst the term of protection runs out in one Member State, it still could be protected in another. According to the judgement in *EMI Electrola v. Patricia*, the expiry of protection provided for an IPR may give third parties the right to manufacture the good in the territories of that State, but does not impede the ability of the title holder to oppose the importation of such goods into other Member States where his title is protected.[23] Both of the above mentioned cases are exceptions to the prohibition of the prevention of parallel importation within the EC.

Once again it must be noted that the regional exhaustion principle does not apply to all of the rights that are attached to an intellectual property. Moral rights stemming from an IP such as the right to protect the integrity of an author's reputation in copyrights or the right to protect the reputation of a trademark, or certain economic rights which help to financially exploit an IP such as public lending or public performance rights remain with the proprietor of an IP even after the exhaustion of the distribution right. For example, in *Basset v. SACEM* the right of public performance of a copyrighted work was protected through the charging of an extra fee in one Member State and the Court ruled that this would not be in breach of Articles 30 or 36 since it must be regarded as a normal

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21 See generally, Michael D. Scott, *Compulsory Licensing of Intellectual Property in International Transactions*, (1988) 11 EIPR 319.

22 Case 19/84 *Pharmon BV v. Hoechst AG* (1985) ECR 2281.

23 Case 341/87 *EMI Electrola GmbH v. Patricia Im- und Export and Others* (1989) ECR 79.

exploitation of copyright.[24] Likewise, in *Warner Bros v. Christiansen* the title holder was allowed to make the hiring out of video cassettes subject to his permission even after his distribution rights were exhausted.[25].

III. 2 US Law

Since 1873, US law has been governed by the territorial exhaustion principle. However, in recent years, there has been a move towards the international exhaustion of copyrights. Due to this difference of approach, patents, trademarks and copyrights shall be discussed separately.

The exhaustion doctrine was first established in the field of *patents*, by the US Supreme Court in *Adams v. Burke*.[26] The Court based its judgement on the reward theory, whereby once the patent holder gets a reward by putting the protected products on sale in the US, he can no longer interfere with the movement of such products within the US.

Territorial exhaustion and the ability of title holders to prevent parallel imports in the area of patents were introduced in *Boesch v. Gräff*.[27] In this case, an importer who had purchased patented products in Germany from a producer who held a German patent, was precluded from importing these products into the US by the owner of a parallel patent in the US. According to the Supreme Court, a foreign patent could not override the exclusivity of a US patent in the US and "the sale of articles in the United States under a United States patent could not be controlled by foreign laws."[28] This judgement of the Supreme Court clearly rules out the international exhaustion principle from the area of patent law in the US.

The principle of territoriality as established in the area of patents was extended to *trade marks* in *A. Bourjois & Co. v. Katzel*.[29] It was decided that the sale in the US of goods produced under a French trademark infringed the rights of the owner of the same trade mark in the US and that only the owner of the US trade mark could exercise the right of selling goods under that trade mark in the US.[30]

The parallel importation of trade marked goods into the US is not totally impossible. Under Section 526 of the US Tariff Act of 1930, US trade mark owners are required by law to give express consent to the importation of identically trade marked goods into the US. However, the

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24 Case 402/85 *G. Basset v. Société des Auteurs, Compositeur et Éditeurs de Musique (SACEM)* (1987) ECR 1747

25 Case 158/86 *Warner Brothers Inc. and Metronome Video ApS v. Erik Viuff Christiansen* (1988) ECR 2605.

26 *Adams v. Burke* 84 US (17 Wall.) 453 (1873)

27 *Boesch v. Gräff* 133 US 697 (1890).

28 *Ibid;* as quoted in Yusuf and Moncayo von Hase, *supra* note 4 at 124.

29 *A. Bourjois & Co. v. Katzel*, 260 US 689 (1923).

30 Paine, L. S. *The Copiat Case, The American Centrafarm?* (1988) 2 EIPR pp. 56-59 at 57.

US Customs Services issued regulations that eliminated the requirement of express consent from the importation of trade marked goods (i) if the foreign and domestic trade mark owners were the same or affiliated companies or (ii) if the foreign goods were made under licence granted by a US trade mark owner.[31] This practice of the Customs Service was challenged by COPIAT, the Coalition to Preserve the Integrity of American Trade mark. The Supreme Court decided that only the latter practice of the Customs Service, ie. that which waived the requirement of express consent for imports of goods produced by foreign licencees, was contrary to the Tariff Act of 1930.[32]

Under the *COPIAT* judgement, the parallel importation of goods into the US produced by a foreign licencee is only possible with the express consent of the US trade mark owner, weheras the parallel importation of goods manufactured by the US trade mark owner, or one of his subsidiaries, and marketed in a foreign country is permitted in principle, but can be prevented by the trade mark owner. This distinction is likely to negatively affect independent importers, who are now obliged to investigate the source of original goods to be bought from a foreign market, as the judgement seems to legalise the parallel importation of original goods carrying the trade mark of the US owner or his subsidiaries. However, as long as the possibility exists to prevent the parallel importation of original goods, the result is that territorial exhaustion is recognised in favour of domestic title holders.

Territorial exhaustion is also recognised in the area of *copyright* under the US Copyright Act of 1976, which enables the owner of copyright in a work to prevent all unauthorised persons from reproducing, distributing and publicly performing the work, as well as importing it. However, there seems to be a tendency in the case law towards the international exhaustion of copyrights. In the *Sebastian* case, where goods exported under the copyrighted label of Sebastian were reshipped into the US, the Court of Appeals for the Third Circuit held that the US copyright owner could not prevent the parallel importation of these products, since he had been rewarded upon the first sale and he did not deserve a second reward on the occasion of importation.[33] According to this judgement, the right of importation of the copyright owner is exhausted, together with the right of first sale, even if the first sale is made outside the US.

The question of parallel importation came up in another case involving the importation of copyrighted goods from Japan. In *Red Baron*, printed circuit boards of a video game were produced in Japan and

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31 Yusuf, Moncayo von Hase, *supra* note 4 at 123.

32 *United States of America et al. v. Coalition to Preserve the Integrity of American Trademarks*, 790 F. 2d. 903 (DC Cir. 1986.)

33 *Sebastian International, Inc. v. Consumer Contacts (PTY) Ltd.*, 847 F. 2d 1093 (3d Cir. 1988); as cited in R. H. Stern, *Some Reflections on Parallel Importation of Copyrighted Products into the United States and the Relation of the Exhaustion Doctrine to the Doctrine of Implied Licence* 1989: 4 EIPR pp. 122-130 at 122. (This seems to be an exceptional case where the plaintiff had and invoked copyright protection for a label on a shampoo bottle, instead of a trade mark.)

marketed in the US by the Japanese company's US subsidiary, who held the copyright in the US.[34] The copyrighted video game printed circuit boards were purchased in Japan by Red Baron, a video game arcade operator, from the Japanese producer and were imported into the US for sale on the US market. The Court held that the US copyright owner could not prevent the importation of the concerned articles, despite the ownership of a US copyright, as the exhaustion doctrine did not depend on where the goods were made and sold.[35]

There appears to be a breakthrough in the area of US copyright law regarding the exhaustion principle. It seems that the judgements in *Sebastian* and *Red Baron* lead to international exhaustion of copyrights by rendering the place of manufacture, and, more importantly, of sale, irrelevant in the determination of the exhaustion of rights. The judgement in *Red Baron* also uses the reward theory employed in previous cases, stating that "the sale of a good by a copyright holder not only provides him the just reward for that particular sale but also for any future sales." By comparison, in EC law the reward theory constitutes a secondary reasoning to the exhaustion theory. As shown in *Merck v. Stephar*, the protection of the free movement of goods has priority over the protection of the reward for the title holder.[36] However, the protection of the free movement of goods has this priority only as regards intra-EC trade. The protection of the exclusive rights of the title holder gains immediate importance when trade with third countries is concerned. From this aspect, the exhaustion of copyrights as applied in the US has a more consistent and equitable characteristic.

It should also be noted here that what has been said so far regarding the exhaustion of intellectual property rights in American law only concerns the rights of marketing, sale and distribution and not *inter alia*, of reproduction, public rental or public performance.

III. 3 GATT Law

In this section, it will briefly be discussed whether the territorial exhaustion of intellectual property rights is consistent with the requirements of the GATT and of the TRIPS Agreement.

Article III (4) of the GATT, which sets out the national treatment principle, states that;

> "The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of laws, regulations and requirements

34 *Red Baron – Franklin Park, Inc. v. Taito Corp.*, Civ. No. 88-156-A, E. D. Va. (29 August 1988 order of summary judgement); as cited in Stern R.H., *ibid.*

35 Stern R. H. *ibid*, at 124.

36 Case 187/80 *supra* note 20.

affecting their *internal sale, offering for sale, purchase, transportation, distribution or use.*"
(emphasis added)

The territorial exhaustion principle is inherently discriminatory since it allows the title holder to prohibit the sale and distribution of imported goods whilst the title holder can not prohibit the sale and distribution of local goods.[37] The principle gives priority to the exclusive importation right of the domestic title holder. Relying on this right, the title holder can prevent the importation into, and therefore the sale and distribution in, the domestic market of original products coming from third countries. However, the same title holder does not have the right to prevent, or even control, the sale and distribution of original local products within the domestic market. Such differential treatment of local and foreign products, both of which are "original", ie. produced with the knowledge and consent of the title holder, is clearly discriminatory treatment and is contrary to one of the fundamental principles of the GATT.

Under Article XX(d) of the GATT, which brings an exception to Article III, the Contracting Parties are allowed to adopt measures necessary to secure compliance with GATT consistent laws including, *inter alia*, those relating to the protection of patents, trade marks and copyrights. However, such enforcement of domestic laws should not constitute a "means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade." However, territorial exhaustion gives the title holder the right to prevent the parallel importation of goods coming from a third market. Accordingly, the title holder can simply prevent the entry into the domestic market of any number and kind of original products on the grounds that they come from a third country. Such an act constitutes an evident restriction to trade, let alone a disguised one. The European Court of Justice has openly recognised that the prevention of parallel imports may constitute a quantitative restriction to trade.[38] Article XI (1) of the GATT, which eliminates all quantitative restrictions on imports, constitutes another main principle of the GATT. The prevention of parallel imports is totally inconsistent with this important provision as well.

As seen, according to Article XX (d), the enforcement of domestic laws to protect intellectual property should not be discriminatory and should not constitute a disguised restriction to trade. This includes procedural laws which may create discriminatory treatment between the procedures of resolution of international disputes and domestic disputes. One good example to this is the GATT Panel ruling ont the dispute involving patents between a Dutch company called AKZO and a US company called Du Pont which resolved that Section 337 of the US Trade Act of 1930 (unamended) on protection against unfair trade involving IPRs,

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37 Yusuf, Moncayo von Hase, *supra* note 4 at 128.

38 Cases 51/75 *supra* note 17, see quotation cited from the ECJ ruling in *EMI Records v. CBS UK.*

created discriminatory treatment between foreigners and US nationals since disputes involving foreigners were resolved by the US International Trade Commission and were tied to a more stringent time scale as opposed to disputes involving only US nationals which were resolved in federal courts where the procedures were less strict.[39]

With the exception of Article XX (d), the GATT does not contain a section which is directly linked to the protection of intellectual property rights. However, the Contracting Parties have been negotiating on Trade Related Aspects of Intellectual Property Rights (TRIPS) within the scope of the Uruguay Round Negotiations of the GATT. Art. 6 of the TRIPS Agreement concerns the exhaustion of intellectual property rights. This Article has been a cause of controversy between developing and smaller countries on the one hand and developed countries and countries that already have access to a large market on the other hand.

This type of conflict has marked the TRIPS negotiations in many issues. The core of the dispute arises from the fact that developed countries, which have hi-tec industries, try to persuade developing countries to adopt stricter laws for the protection of intellectual property. The developing countries are not willing to agree to this proposal, since they believe that stricter protection of intellectual property would limit their access to higher technologies or certain products such as pharmaceuticals which are essential for public health. The territorial exhaustion of intellectual property rights enables the title holder to divide different markets and isolate them from competition, thus raising prices of goods. Such a result is not favourable from the point of view of developing countries. In addition, the ability to prevent parallel imports does not benefit smaller countries who are dependent on imports and who do not have access to a large domestic market, unlike the EC countries and the US.[40]

The conflict between different sides has not been resolved so far. Article 6 of the TRIPS Agreement, relating to the exhaustion of IPRs does not change the existing legal situation. Those countries which prefer international exhaustion have the ability to exercise it, whilst others, who favour territorial exhaustion, may employ this in their legislation. However, one important point is that although Article 6 does not alter the existing system, it condones it. The arguments that have been made about the inconsistency of territorial exhaustion with basic GATT principles seem to lose their value since the current situation is declared as the status quo under the internationally recognised TRIPS Agreement, which will be the case until a Contracting Party attempts to challenge the GATT consistency of Article 6.

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39 DuPont/Akzo Dispute: EEC v USA (GATT Panel Ruling) (1989) 1 CMLR 715. See also, in favour of this opinion Robert Lee and John Hull, *Technology, Trade and World Competition*, (1990) 1 EIPR 3, and against the opinion, M.B. Devine, *The Application of EEC Regulation 2641/84 on Illicit Commercial Practices with Special Reference to the USA*- (1988) 22 Int'l Lawyer 1091.

40 Howard A., Reinbothe J. *The State of Play in the Negotiations on Trips (GATT/ Uruguay Round)*, (1991) 5 EIPR pp. 157-164, at 159.

IV. Arguments For And Against Territoriality of Exhaustion

IV. 1 Arguments in Favour of Territorial Exhaustion

a) Maximising the profits of the title holder

Territorial exhaustion brings a system which benefits the proprietors of intellectual property rights more than any other party. The owner of a patent invests considerable amount of time and money in research and development and later on in efforts to render the innovation economically exploitable and recognised by the public as of a certain level of quality. The marketing of such products only in the domestic market may not cover the costs invested in the manufacturing process. Therefore, innovators try to sell in third country markets to recoup their investments. One of the devices that can be used in the distribution process is to divide markets and give exclusive distribution rights within different territories which will be "locked" against imports. This system enables the innovator to spread the risks involved in the developing and marketing of the product.[41] In addition, royalties will be paid for every different market. Profits can also be maximised through the adoption of different pricing policies, according to the different elasticities of demand and supply within each isolated market.

It is argued that the theory of international exhaustion prevents the proprietors of intellectual property rights from exploiting such monopoly rights and reduces their profit. Subsequently, this may decrease the interest of potential investors in industries that require innovative and costly business efforts.

In addition, under an international application of the principle of exhaustion, the level of royalties may also decline. In the case of international exhaustion of rights, products can be distributed freely once they are lawfully put on the market in any country. This creates the possibility to purchase the same product from a market where the price of the concerned product may be lower. Subsequently, in countries where higher royalties are required by the licensor, companies may choose to buy the products from those markets where they are sold at lower prices, instead of paying higher royalties to produce the product domestically. The decline in royalties may in turn discourage new inventions.

b) Encouraging local availability

Another aspect of territorial exhaustion is the possibility to grant multiple exclusive licences valid in different territories. This is said to encourage local supply and availability.[42] Whereas under an

41 Paine L. S. *supra* note 30 at 58.

42 C. Bradley, *The Role of GATT in Intellectual Property*, (1991) XXV 3 UNESCO Copyright Bulletin.

international application of exhaustion obtaining such exclusive territorial rights would no longer be beneficial, since parallel imports would create competition, tehereby preventing the licensee from exploiting his exclusive rights. This result would discourage local supply and availability.

c) A barrier against "grey" imports

Under territorial exhaustion, parallel imports may be prevented. As mentioned before, parallel imports are imports of "original goods" that are lawfully marketed in a third country by, or with the consent of, the title holder. However, the "originality" of the goods can be subject to question. Products that are manufactured in many different parts of the world may be geared towards consumption in a particular territory. For example, a word processor manufactured in France may have exactly the same design and functions as another one manufactured in the US, whilst having a French keyboard instead of an English one. Although both of these word processors may be identical in function and system, they are not identical in one respect, which despite being a small detail may pose difficulties in the usage of the product. Such goods are not "original" (identical), but "grey" (non-identical) goods. The importation of such products may damage consumer confidence in the intellectual property which has been built up in a certain territory. Under the territorial application of exhaustion, it is possible to prevent grey imports together with parallel imports; however, this may not be possible under international exhaustion of IPRs, which is a threat towards both consumers and producers.

IV. 2 Arguments Against Territorial Exhaustion

a) Inconsistency with GATT principles

As explained in section III. 3 above, territorial exhaustion results in discrimination between foreign and domestic products and creates a quantitative restriction to trade, both of which are contrary to the basic principles of the GATT. For all states who are signatories of the GATT, this constitutes an infringement of their obligations arising from a widely recognised international agreement. International exhaustion, however, precludes the application of discriminatory treatment and quantitative barriers to trade, since it allows for parallel imports and the free distribution of products once they are lawfully placed on the market.

b) Excessive exploitation of monopoly rights

Territorial exhaustion enables the title holder to assign exclusive licences to different territories and to isolate these markets through the

blocking of parallel imports. Such a policy of market division drastically reduces competition, and allows the title holder or his licencees to enjoy a monopolistic position in every market. Relying on these monopoly rights, title holders and licencees can try to exploit their strong position at the expense of consumers, who have to suffer higher prices. Therefore, territorial exhaustion reduces consumer welfare.

c) Protectionism

The exclusive importation rights granted by territorial exhaustion result in the protection of the domestic market and its industry against outside competition. For developing countries, who are dependent on exports for economic growth, this results in the loss of important markets.

Moreover, the possibility to grant exclusive licenses for different territories enables the title holder to reserve certain territories as his own distribution network.[43] This type of reservation of territories limits the availability of different import markets and different prices. Such a situation may carry considerable importance for countries who are dependent on imports of pharmaceutical products or modern technologies.

d) Developments in IP protection

One of the arguments in favour of territorial exhaustion is that of differences in the levels of IP protection provided by different countries. The level of protection is especially important for industrialised countries, who have high levels of technology and who invest heavily in new inventions. Therefore, during the TRIPS negotiations, the industrialised countries tried to convince the developing countries about the necessity of having higher levels of protection for IPRs. Although the definite outcome is not yet known, an important improvement can be considered to have been made through moves towards the closer harmonisation of IP protection in different countries. A development

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43 For example, in *Beecham Group v. International Products* ([1968] RPC 129), decided by the High Court of Kenya, the plaintiffs, who had licensed an American company to distribute a product throughout the world except in the British Commonwealth, were held to be entitled to prevent the distribution of the concerned product by the defendant, a Kenyan purchaser, despite the fact that the products were purchased directly from the American company in New York and not in Kenya where the American Company was not licenced to sell. The judgement was based on the principle that the purchaser could not acquire more rights than the licensee had. Therefore, even though there was no express limitation upon the purchase of the protected products as to how they could be disposed of, the limitation that bound the licencee was held to bind the purchaser. Thus, the title holder was able to divide the world market in the way that would maximise his profits.
See, D. Gladwell, *The Exhaustion of Intellectual Property Rights*, (1986) 12 EIPR pp. 366-370 at 368.

towards the adoption of higher levels of IP protection could counter arguments in favour of territorial exhaustion.

In addition, the circumstances that surround the developing countries and their special needs must also be taken into consideration. It should not be forgotten that protection of IPRs increases with development and that some industrialised countries did not attempt to protect IPRs until their industries had developed.[44] The LDCs would largely benefit from international exhaustion, while the industrialised countries would benefit from an increase in levels of protection of IPRs. Adopting the principle of international exhaustion could be used as a concession made to LDCs to obtain their consent in granting higher IP protection.

V. Conclusion

The principle of exhaustion determines the limit of exploitation of intellectual property rights by the title holders. The application of this principle differs between various legal systems. It can be concluded from the discussion in section III that the more favoured applications of the principle of exhaustion are regional and territorial. While regional exhaustion promotes free trade inside a predetermined area (a congregation of different countries), it continues to sustain trade barriers against the rest of the world. Territorial exhaustion on the other hand gives a definite priority to the exclusivity of the IPRs granted within that territory as opposed to the rights of third people to legally penetrate that territorial market.

A comparison of the arguments for and against territorial exhaustion listed in section IV, leads to the conclusion that territorial exhaustion mostly benefits the proprietor of an IPR, whereas international exhaustion benefits larger categories of people, including, *inter alia*, parallel IPR holders, licencees, independent traders and last but not least, large masses of consumers throughout the world.

As a result of this comparison, it can be said that an international application of the principle of exhaustion of IPRs leads to more equitable results in terms of general welfare and should be adopted instead of territorial exhaustion. However, the pressure that can be exerted on lawmakers by a lobby of industrialists who possess IPRs can be much stronger than the feeble opposition voiced by consumers or importers. Consequently, it can be presumed that the adoption of an international exhaustion of IPRs will take time and effort and will be a costly procedure involving many cases between IPR holders and independent merchants.

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44 R. Dhanjee, L. B. De Chazournes, *Trade Related Aspects of Intellectual Property Rights (TRIPS): Objectives, Approaches and the Basic Principles of the GATT and of Intellectual Property Conventions*, (1990) (24) (5) JWT pp.5-15 at 8.

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