The Impact of the Supreme Court's Decision in *Costco v. Omega* on Libraries

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On December 13, 2010, the U.S. Supreme Court decided *Costco v. Omega* in a manner that eliminated none of the uncertainty caused by the lower court's ruling in that case. The U.S. Court of Appeals for the Ninth Circuit had ruled that the copyright law's "first sale doctrine" did not apply to copies manufactured abroad. This ruling cast doubt on a library's ability to circulate books and other materials manufactured outside of the United States. In a 4 to 4 vote, the Supreme Court affirmed the lower court's judgment "by an equally divided Court." This means that the Ninth Circuit's ruling stands within the Ninth Circuit, but is not a binding precedent on courts in the rest of the country. Libraries must now decide whether to change their purchasing and lending practices in light of the Supreme Court's decision. This memorandum suggests that a combination of defenses, including section 602(a)(3)(C) of the Copyright Act, the Ninth Circuit's *Drug Emporium* exception, implied license, and fair use, allow libraries throughout the country to continue their existing purchasing and circulation practices with a fair degree of confidence that they will not infringe copyright by doing so.

I. Background

Section 106(3) of the Copyright Act grants the copyright owner the exclusive right "to distribute copies or phonorecords of the copyrighted work to the public by … lending." 17 U.S.C. § 106(3). However, the first sale doctrine, codified at section 109(a) of the Copyright Act, terminates the copyright owner's distribution right in a particular copy "lawfully made under this title" after the first sale of that copy. 17 U.S.C. § 109(a). The House Judiciary Committee Report on the 1976 Copyright Act explains that under

section 109(a), "[a] library that has acquired ownership of a copy is entitled to lend it under any conditions it chooses to impose." H.R. Rep. No. 94-1476, § 109, at 79 (1976), *as reprinted in* 1976 U.S.C.C.A.N. 5659, 5693. The first sale doctrine thus is critical to the operation of libraries: "[w]ithout this exemption, libraries would be unable to lend books, CDs, videos, or other materials to patrons." Carrie Russell, *Complete Copyright: An Everyday Guide For Librarians* 43 (2004).

The *Costco* case concerns the meaning of the phrase "lawfully made under this title" in section 109(a). Costco, the discount retailer, sold Swiss-made Omega watches without the permission of Omega or its U.S. distributor. Costco purchased the watches from distributors in Europe and then imported them to the United States. In response, Omega engraved a design of a globe on the back of its watches and registered the design with the Copyright Office. When Costco imported watches engraved with the design, Omega sued Costco for infringing its importation and distribution right in the design. Costco contended that the import and sale was permitted under the first sale doctrine, but Omega argued that the first sale doctrine did not apply to copies manufactured abroad. The Ninth Circuit agreed with Omega, holding that copies "lawfully made under this title" meant copies lawfully manufactured in the United States. Based on this interpretation, the Ninth Circuit ruled that the first sale doctrine did not apply to the designs engraved in Switzerland.

At Costco's request, the Supreme Court agreed to review the Ninth Circuit's holding. The members of the Library Copyright Alliance – the American Library Association, the Association of Research Libraries, and the Association of College and Research Libraries -- filed an amicus brief in support of Costco, urging reversal of the

Ninth Circuit. LCA argued that by restricting the application of section 109(a) to copies manufactured in the United States, the Ninth Circuit's decision threatened the ability of libraries to continue to lend materials in their collections. LCA explained that many of the materials in the collections of U.S. libraries were manufactured overseas. Indeed, U.S. publishers now print an increasing number of books in China and other countries with lower labor costs. Additionally, because the copyright law treats importation as a form of distribution, the Ninth Circuit's narrow interpretation of the first sale doctrine could limit the ability of U.S. libraries to import materials manufactured outside the United States.

II. The Supreme Court's Decision

Justice Kagan recused herself, presumably because she had filed a brief in an earlier phase of the case when she was still the Solicitor General. After Costco had petitioned the Supreme Court to review the Ninth Circuit's decision, the Supreme Court asked the Solicitor General for the views of the United States government on whether it should hear the case. Then Solicitor General Kagan filed a brief arguing that the Ninth Circuit had correctly decided the case and the Supreme Court should therefore reject Costco's petition for review.

Justice Kagan's recusal created the opportunity for an "equally divided Court." The Court's decision issued on December 13, 2010, contains no opinions nor explanation of how each of the eight participating justices voted.[1] The entirety of the decision is: "The judgment is affirmed by an equally divided Court. Justice Kagan took no part in the

[1] The oral argument on November 8, 2010, provides clues as to the views of some of the justices, but it is unknown how the justices actually voted. It should be noted, however, that at oral argument Justice Kennedy specifically referenced the LCA brief twice by name, and Justice Breyer mentioned the potential impact of the case on libraries.

consideration or decision of this case." As noted above, affirmance by an equally divided court means that the Ninth Circuit's decision stands within the Ninth Circuit (California, Oregon, Washington, Alaska, Arizona, Idaho, and Nevada), but is not binding on courts elsewhere in the United States. The Supreme Court simply affirmed that within the Ninth Circuit, the first sale doctrine does not apply to foreign manufactured copies. Outside the Ninth Circuit, the scope of the first sale doctrine remains as it was.

However, most other circuits have not considered this issue. District courts in New York recently agreed with the Ninth Circuit's holding, but these cases are now on appeal to the Second Circuit. What should libraries, both within the Ninth Circuit and elsewhere in country, do now?

III. The Way Forward for Libraries

In the wake of the Supreme Court's decision, the basic rule within the Ninth Circuit is that the first sale doctrine does not apply to copies manufactured outside of the United States. Furthermore, unless the Second Circuit disagrees with the Ninth Circuit when it finally rules on this issue, libraries outside the Ninth Circuit should probably assume that courts in their circuit will follow the Ninth Circuit's rule.

Nonetheless, there are several significant exceptions that could mitigate the harm on library operations inflicted by this rule.

A. The *Drug Emporium* Exception.

The Ninth Circuit in *Parfums Givenchy, Inc., v. Drug Emporium, Inc*., 38 F.3d 47 (9th Cir. 1991) and *Denbicare U.S.A. Inc. v. Toys "R" Us, Inc.,* 84 F.3d 477 (9th Cir. 1996), fashioned an exception to its rule that the first sale doctrine does not apply to foreign manufactured copies. Under the *Drug Emporium* exception, parties can raise the

first sale defense in cases involving foreign-manufactured copies so long as an authorized domestic sale had occurred. In other words, if a publisher authorizes the importation and sale of copies of a foreign printed book, libraries that purchase those copies have first sale rights with respect to them.

While the *Drug Emporium* exception could be extremely helpful to libraries, it has limits. First, the exception applies only to copies purchased in the United States, not to copies purchased in another country. Libraries (or their agents) purchase many books and other materials directly from foreign publishers or distributors. The *Drug Emporium* exception would not extend the first sale doctrine to these copies. Second, a library could comfortably rely on the *Drug Emporium* exception only if it maintained records that it had purchased the material in the United States.

Third, although the Ninth Circuit's basic rule that the first sale doctrine does not apply to foreign manufactured copies has a basis in the wording of section 109(a), the *Drug Emporium* exception lacks a clear statutory basis. Rather, it appears that the Ninth Circuit created the exception to reduce the adverse policy implications of its basic rule – for example, encouraging U.S. companies to manufacture products overseas so as to be able to avoid the first sale doctrine and exert control over the resale of their products. The absence of a clear statutory basis for the *Drug Emporium* exception suggests the possibility that courts in other circuits might adopt the Ninth Circuit's basic rule but reject the *Drug Emporium* exception. Indeed, a district court in New York has questioned the validity of the *Drug Emporium* exception.[2] Nonetheless, until a court in a library's jurisdiction rejects the *Drug Emporium* exception, there is no compelling reason for a library to assume that courts in its jurisdiction would not follow the *Drug Emporium*

[2] *See Pearson v. Liu*, 656 F.Supp.2d 407, 415 (S.D.N.Y. 2009).

exception. The library, therefore, could reasonably take the position that the *Drug Emporium* exception applies to copies it purchases from authorized distributors in the United States.[3]

B. The Section 602(a)(3)(C) Exception.

The Copyright Act also contains an exception that provides libraries with some assistance. 17 U.S.C. § 602(a)(3)(C) states that the section 602(a) prohibition on importation does not apply to

> importation by or for an organization operated for scholarly, educational, or religious purposes and not for private gain, with respect to no more than one copy of an audiovisual work solely for its archival purposes, and no more than five copies or phonorecords of any other work for its library lending or archival purposes….

This exception largely fills the hole in the Ninth Circuit's *Drug Emporium* exception. As discussed above, *Drug Emporium* extends the first sale doctrine to foreign-manufactured copies sold in the United States with the righsholder's authorization. *Drug Emporium* does not apply to copies purchased abroad, but this exactly what section 602(a)(3)(C) reaches.

The section 602(a)(3)(C) exception contains several limitations. First, although the section 602(a)(3)(C) exception clearly permits a library to *import* five copies for "its library lending or archival purposes," the exception by its terms does not actually permit the library to *lend* those copies. In other words, section 602(a)(3)(C) creates an exception to the section 602(a) importation right, but not explicitly to the entire section 106(3) distribution right. To be sure, an exception to the distribution right is implied – Congress is permitting the library to import the copies specifically for "library lending …

[3] Going forward, libraries should maintain careful records of their purchases from U.S. distributors in order to demonstrate that those purchases fall within the *Drug Emporium* exception.

purposes." It would make no sense for Congress to allow importation for the purpose of lending, but then not allow the lending itself. Nonetheless, a court might erroneously conclude that section 602(a)(3)(C) does not permit the lending of the imported copies.

Second, even if section 602(a)(3)(C) were construed to permit the lending of the five imported copies, this permission would not apply to audiovisual works. The provision specifically allows a library to import "no more than one copy of an audiovisual work *solely for its archival purposes*." 17 U.S.C. § 602(a)(3)(C)(emphasis added.) Because this exception for the importation of a copy of an audiovisual work is limited to archival purposes, the exception cannot reasonably be interpreted as implying that a library can lend that imported copy.[4]

3. Implied License and Fair Use

Taken together, the *Drug Emporium* and section 602(a)(3)(C) exceptions cover the vast majority of copies of materials currently in the collections of U.S. libraries, or likely to be purchased by libraries in the future.[5] Still, at a minimum these exceptions will leave a gap with respect to a library's ability to lend two categories of foreign manufactured copies without an authorized domestic sale: copies of audiovisual works; and copies of other kinds of works in excess of five copies. (This gap could be significantly broader if courts reject the *Drug Emporium* exception or construe section 602(a)(3)(C) to apply only to importation and not circulation.) Libraries can rely on two

[4] 17 U.S.C. § 602(a)(3)(A) states that the section 602(a) prohibition on importation does not apply to "importation of copies or phonorecords under the authority or for the use of the Government of the United States or of any State or political subdivision of a State, but not including copies or phonorecords for use in schools, or copies of any audiovisual work imported for purposes other than archival use." This exception arguably expands the section 602(a)(3)(C) exception for a public library by allowing it to import and lend more than five copies of an audiovisual work. This expansion would occur only if a court inferred permission to lend from the permission to import for the use of a political subdivision of a state. A public university could benefit from this provision only if a court found that it was not a "school."

[5] Excluded from this discussion are digital materials licensed by libraries, a large and growing category.

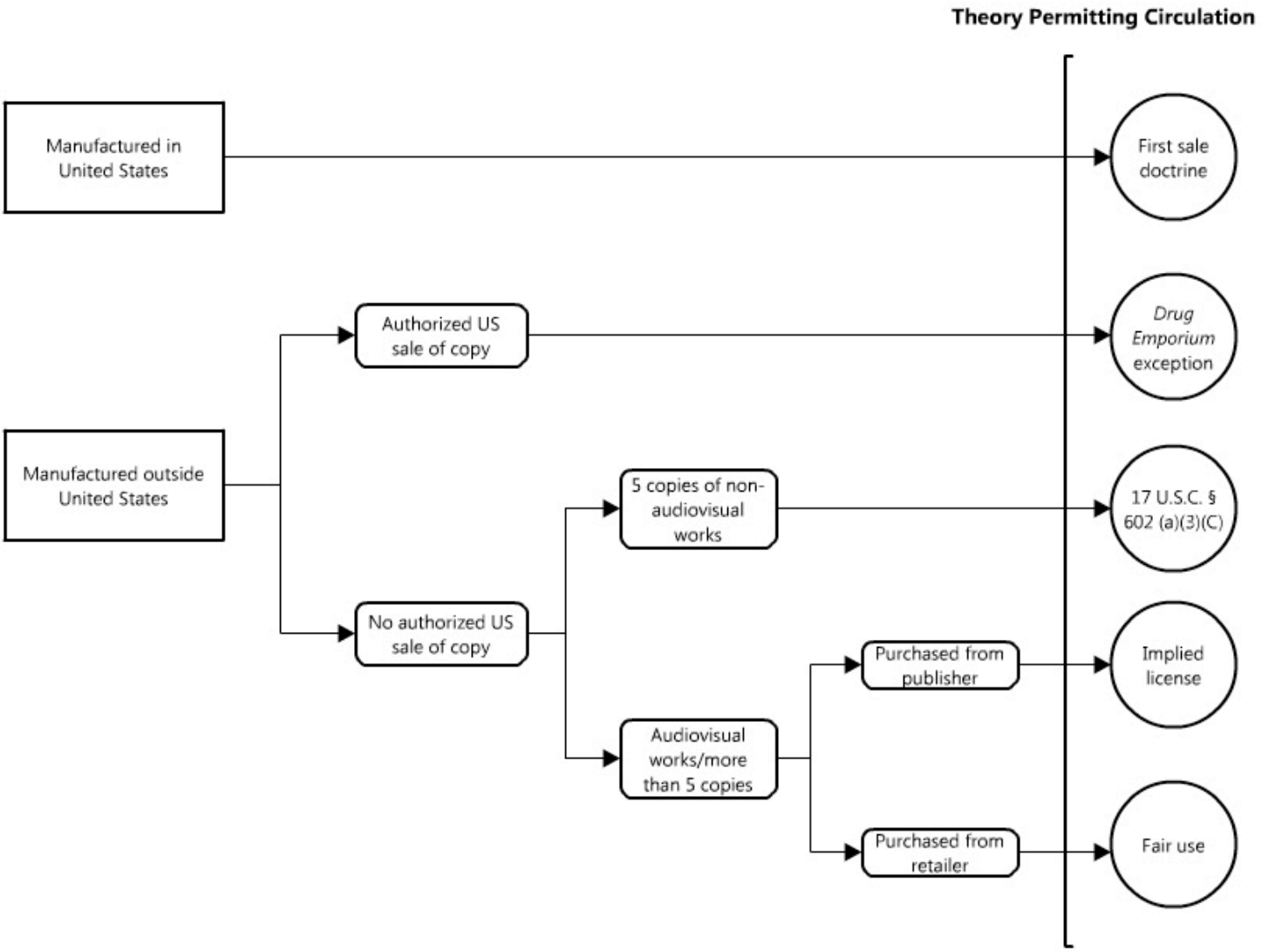
legal theories to fill this gap: implied license and fair use.

The implied license theory would work best when a library purchases a foreign-manufactured copy directly from the publisher or an exclusive distributor that knew it was selling the copy to a library. The library could argue that the publisher or distributor knew that the library intended to lend the copy, and that by selling the copy without explicitly prohibiting its circulation, the publisher or distributor consented to it. The library would have greater difficulty prevailing in this defense if it purchased the book from a retailer that might not have had the legal authority to grant a license to lend. Moreover, the library might not have any record of who sold it the copy, particularly with copies it purchased decades ago.

The library could also contend that fair use permits its lending, particular when an implied license argument is not available. Library lending enables the statutorily identified purposes for fair use: "criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, or research…." 17 U.S.C. § 107. Library lending also falls squarely within the purpose and character listed in the first factor: "nonprofit educational purposes." *Id*. The absence in the United States of "lending licenses" indicates that a lending license does not constitute a traditional market for purposes of the fourth fair use factor – the effect of the use on the potential market for the work. Additionally, library lending facilitates users' exercise of their First Amendment right to receive information. Finally, the four hundred year tradition of libraries lending books and other materials to users, and the privileged status Congress has accorded libraries in Title 17, buttress the library's argument that circulating materials qualifies as a fair use. These arguments apply even more forcefully when the rightsholder does not

distribute the work in the United States, and does not appear to have any intention to do so. Although one cannot predict with certainty how a given trial court would perform the fair use calculus, a court should find these arguments compelling and hold that fair use permits library lending.

Library Lending After *Costco v. Omega*



IV. Conclusion

The Supreme Court's decision in *Costco* leaves many unanswered questions: Will other circuits follow the Ninth Circuit's basic rule? If so, will they adopt the *Drug Emporium* exception? Does section 602(a)(3)(C) permit the circulation of copies imported by libraries? Is library lending permitted under an implied license or fair use theory? Nonetheless, until there is a clear ruling to the contrary, libraries throughout the United States should assume that the *Drug Emporium* exception is available to them. They should also assume that section 602(a)(3)(C) permits circulation of copies of non-audiovisual works. Finally, they should assume that courts would treat circulation not permitted by another exception as a fair use.[6]

[6] This generally positive conclusion is not inconsistent with the position taken by LCA in its amicus brief in *Costco*. LCA's major concern was that the Supreme Court would affirm the Ninth Circuit's basic rule while rejecting the *Drug Emporium* exception. LCA argued that if the Court affirmed the Ninth Circuit's basic rule, it should also recognize the *Drug Emporium* exception. *See* LCA Amicus Brief at 37-38. Because the Supreme Court did not disturb the *Drug Emporium* exception, it is still good law.