

Second Report (Final) to the Committee on International Trade Law of the International Law Association on the Subject of the Exhaustion of Intellectual Property Rights and Parallel Importation

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I. Introduction

Study of trade-related aspects of intellectual property rights (TRIPS) has formed an integral part of the work program of the Committee on International Trade Law of the International Law Association (ILA) since its inaugural meeting at the headquarters of the GATT in 1993. In June 1995 in Geneva, the Committee decided to undertake a specific work program regarding the exhaustion of rights and parallel importation. In August 1996 in Helsinki, the Committee considered a preliminary First Report on the Subject of Parallel Importation prepared and presented by this Rapporteur. At that meeting, the Committee authorized wide distribution of a final version of that First Report to interested parties for reaction and comment. This final version took into account comments of Committee members presented at or in connection with the Helsinki meeting. At its June 1997 meeting at the headquarters of the World Intellectual Property Organization (WIPO) in Geneva, the Committee considered the First Report (Final) and the preliminary comments of interested parties.¹ At that meeting, the Committee decided to convene a special meeting on the subject of the First Report to further consider the views of interested parties. This meeting was held in Geneva on November 6-7, 1998, at the Graduate Institute of International Studies.²

A substantial number of Committee members attended this meeting, and several made formal presentations, including Marco Bronckers, William Cornish, Thomas Cottier, and Hans Peter Kunz-Hallstein. This Rapporteur presented and distributed a Discussion Paper on the Exhaustion of Rights and Parallel Importation. The meeting was attended by representatives of international organizations, national/regional governments and industry, as well as by judges and judicial staff, legal scholars, private attorneys and economists. Committee members heard a

*This report presents the views of the Rapporteur and should not be attributed to the Committee as a whole, except as expressly indicated.

¹This report is published at Frederick M. Abbott, *First Report (Final) to the Committee on International Trade Law of the International Law Association on the Subject of Parallel Importation*, 1 JIEL 607 (1998), attached as Annex 1.

²See Conference announcement and preliminary agenda, attached as Annex 2.

number of formal presentations by interested parties, and received several papers (and other data) from those in attendance. At the conclusion of this meeting, Committee members agreed that this Rapporteur should prepare in preliminary form a Second Report on the Subject of the Exhaustion of Rights and Parallel Importation. This preliminary Second Report would incorporate the results of the November 1998 meeting, and would provide a basis for discussion at a meeting of the Committee to be held at WIPO on June 25, 1999. The objective of the June 1999 discussion would be to seek a common Committee position, and to consider a recommendation to the ILA for discussion at its biennial meeting in London in 2000.

The preliminary Second Report, including a proposal for a draft resolution regarding the exhaustion of intellectual property rights (IPRs) and parallel trade, was presented by this Rapporteur to the Committee and discussed at its meeting at WIPO headquarters on June 25, 1999. Following discussion of the preliminary Report, as well as a separate statement from William Cornish, the Committee reached preliminary consensus on a draft resolution, and delegated that task of finalizing a text to this Rapporteur, William Cornish and Thomas Cottier. The Committee also recommended that the preliminary Second Report be finalized by the Rapporteur and published.

The three designated persons jointly prepared the text of a resolution that was circulated to Committee members with the draft full Report of the Committee to the London Conference. That draft resolution was favorably received by Committee members, and accompanies the Report of the Committee. The draft resolution appears at the conclusion of this Second Report.

The draft resolution contains one major substantive recommendation in favor of a rule of international exhaustion regarding trademarks. In regard to copyright and patent, the draft resolution essentially proposes further study by interested parties. The Committee decided that in view of the extensive discussions that it has undertaken on this subject matter, its consensus in one area, and its lack of consensus in other areas, that it would consider its active work program on this subject to be completed.

This Rapporteur continues to support a rule of international exhaustion across the fields of IPRs. He believes that the multilateral adoption of such a rule would promote the efficient allocation of productive resources in the world trading system, and that it would advance the interests of developing countries in building globally competitive enterprises. This Rapporteur considers that the risk of anticompetitive behavior among producers remains high, and that rules permitting parallel trade discourage anticompetitive horizontal collusion that affects world markets. Opening markets to parallel trade would benefit consumers. Recent actions by competition authorities in the United States and the European Union involving integrated pharmaceutical manufacturers,³ among others, affirm the need for vigilance in the protection of competitive markets. This Rapporteur recognizes that there are special circumstances for which exceptions to a general rule of international exhaustion might be made in the interests of social welfare, but considers that existing WTO rules and principles provide adequate flexibility to implement such exceptions.

A number of Committee members are not persuaded that a rule of international

³ [Cite to Vitamins price-fixing conspiracy.]

exhaustion should extend to patents and, though a lesser level of disagreement is evident in this area, to (at least some areas of) copyright.

The Committee has played a substantial role in raising awareness at the national, regional and international levels of the proximate relationship between international trade rules and rules regulating IPRs, and the work of the Committee has stimulated research in this area. The Committee work program on exhaustion of rights and parallel importation has been the subject of attention from those responsible for the formulation of international economic policy. In this respect, the work program of the Committee has already achieved certain of its explicit objectives.

The subject of parallel trade has recently emerged as a major political issue among governments, and within public constituencies. Various members of the Committee will undoubtedly continue to independently study this subject matter, and the Committee may wish to take it up in the future.

This preliminary Second Report is divided into six parts. Following this introduction, the second part describes developments in the field of exhaustion of rights and parallel importation subsequent to completion of the First Report. The third part notes certain interested party reactions to the First Report, and presents this Rapporteur's responses. The fourth part presents the results of the November 1998 meeting in Geneva, including a brief synopsis of each panelist's presentation, followed by a brief Rapporteur's analysis. The fifth part describes and analyzes the international exhaustion issue in the context of digital networks and electronic commerce, as well as in the context of the GATS. The sixth and final part presents the final draft recommendation by the Committee in this field.

II. Developments Since the First Report

A. Decisions of Judicial Bodies

A number of decisions by high-level judicial bodies have been rendered on the subject of parallel importation since the June 1997 presentation of the First Report. The general trend among these decisions is to support the international exhaustion of intellectual property rights and the right of parallel importation, though there are certain notable exceptions.

The first decision on this subject was rendered by the Japanese Supreme Court in the *BBS* case.⁴ This case involved an attempt by a Japanese patent holder (the affiliate of a German parent company) to block the import into Japan (by an unrelated party) of a product protected by a Japanese patent, that product having first been placed on the market in Germany with the consent of the Japanese patent holder. The Japanese Supreme Court held that the holder of a Japanese patent which places its goods on a foreign market implicitly consents to the subsequent importation of that product into Japan. The Court said that the exhaustion of Japanese patent rights was a matter governed by Japanese patent law and that the result under Japanese law was

⁴*BBS Kraftfahrzeugtechnik AG and BBS Japan, Inc. v. Rasimex Japan, Inc.*, Supreme Court Heisei 7 (o) No. 1988 (July 1, 1997), J. of S. Ct., No. 1198 (July 15, 1997). For excerpted translation, see Tadayoshi Homma, *TRIPS and After – A Realist's View*, 13 CHIBA J. L. & POLITICS, No 2, attached as Annex 3.

not affected by whether a patent was held (or exhausted) in Germany. The Supreme Court further indicated that the Japanese patent holder might restrict parallel importation of a product protected by a Japanese patent through a restrictive covenant in a contract of sale for the product, accompanied by notice of the restriction on the product itself, and that this notice might also restrict importation by subsequent purchasers of the product.

The second decision was that of the EFTA Court in the *Maglite* case.⁵ In this case, the holder of parallel trademarks in Norway and the United States sought to block the importation into Norway (by an unrelated party) of a product initially placed on the U.S. market with the trademark holder's consent.⁶ The EFTA Court recognized that EEA countries are generally bound to follow European Union jurisprudence regarding intellectual property, including the rule of intra-EEA exhaustion. The EFTA Court held, however, that since EFTA is a free trade area lacking a common external commercial policy, while the EU is a customs union adhering to a common external commercial policy, that each EFTA country is entitled to adopt its own rule with respect to the international exhaustion of trademark rights. Norway was thus entitled to follow its longstanding rule in favor of international exhaustion.

The third decision was that of the United States Supreme Court in the *Quality King v. L'anza* case.⁷ In this case, the holder of a copyright in the United States sought to block the importation of a work (shampoo packaging) that had first been placed on the U.S. market with the consent of the copyright holder, then exported to Europe to an unrelated purchaser, and subsequently re-transported to the United States. The Supreme Court held that the first sale of the work under the U.S. Copyright Act exhausted the right of the copyright holder to control subsequent importation of the work. The Court did not address the context in which a work

⁵*MAG Instrument Inc. v. California Trading Co. Norway, Ulsteen*, Case E-2/97, 1997 Rep. EFTA Ct. 127, [1998] 1 C.M.L.R. 331 [hereinafter *Maglite*]. An analysis of the *Maglite* case, including consideration of its relationship to the European Court of Justice decision in the *Silhouette* case (see *infra* note 10), is at Carl Baudenbacher, *Trademark Law and Parallel Imports in a Globalized World - Recent Developments in Europe with Special Regard to the Legal Situation in the United States*, 22 FORDHAM INT'L L. J. 645 (1999) [Prof. Baudenbacher is a Judge on the EFTA Court]. This article includes an historical account of decisions of EEA member state decisions regarding exhaustion and parallel importation.

⁶According to Prof. Baudenbacher:

The plaintiff in the proceedings before the Fredrikstad City Court (Fredrikstad Byrett), Mag Instrument, Inc., was a U.S. company that produces and sells the so-called Maglite lights. In Norway, Viking International Products A/S, Oslo, was the authorized sole importer and sole distributor for those products. The trademark was registered in Norway in the plaintiff's name. The defendant, California Trading Company Norway, Ulsteen, had imported Maglite lights directly from the United States into Norway for sale in Norway, without the consent of the plaintiff. The plaintiff brought proceedings against the defendant before the national court, arguing that the imports infringed its exclusive trademark rights. *Id.* Fordham, at 650.

⁷*Quality King Distributors v. L'anza Research International*, U.S. Supreme Court, 1998 U.S. LEXIS 1606 (1998).

protected by a U.S. copyright was first placed on a market outside the United States. However, the unanimous Court expressed clear reservations about the use of intellectual property rights to enforce international price discrimination.

The fourth decision was that of the Swiss Federal Court in the *Nintendo*⁸ case. In its decision, the Court extended Switzerland's rule of international exhaustion in the field of trademarks⁹ to the field of copyrighted works. In the *Nintendo* case, a producer of video games holding parallel copyright protection in Switzerland and the United States sought to block the importation into Switzerland of games first placed on the market in the United States with its consent. The Swiss Federal Court found no basis for adopting a different approach with regard to copyright than it had adopted in respect to trademarks in the *Chanel* case. It said that holder of parallel copyrights made the decision upon which market to first place its work, and that it received its economic return from this first marketing.¹⁰

The fifth decision was that of the European Court of Justice in the *Silhouette* case.¹¹ This case involved an action by an Austrian trademark holder to prevent the importation into Austria of goods that it had exported and sold to an unrelated purchaser in Bulgaria (outside the EEA). A third party sought to export the same goods from Bulgaria and resell them in Austria without the consent of the Austrian trademark holder. The ECJ interpreted Article 7(1) of the First Trade Marks Directive to mandate that member states of the EU (and EEA) follow a rule of intra-EU exhaustion of trademark rights, and that the Directive precluded the member states from adopting a rule of international exhaustion. Austria was therefore precluded by the Trade Marks Directive from continuing to follow its rule of international exhaustion in the field of trademarks.

Following the *Silhouette* decision, the European Commission (at the request of the Council) examined whether action should be taken at the EU level to move to a rule of international exhaustion in the field of trademarks. The Commission's efforts are reported on in the next section of this report.

Subsequent to the ECJ decision in *Silhouette*, the High Court (Chancery Division) of the United Kingdom (Justice Laddie) in the *Davidoff*¹² case ruled that, despite the decision in

⁸*Imprafot AG v. Nintendo Co. et al.*, Swiss Federal Supreme Court, No. 4C.45/1998/zus, July 20, 1998.

⁹*Chanel SA, Geneva and Chanel SA, Glarus v. EPA SA*, BGE 122 II 469, Oct. 23, 1996.

¹⁰See Baudenbacher, *supra* note 5, at 688.

¹¹*Silhouette International Schmied Gesellschaft mbH & Co. KG v. Hartlauer Handelsgesellschaft mbH*, Case C-355/96, [1998] E.C.R. I-4799, [1998] 2 C.M.L.R. 953. Advocate General Francis Jacobs recommended to the ECJ that it decide the First Trade Marks Directive required EEA member states to exclusively follow a rule of intra-Union exhaustion. The opinion of the Advocate General was critically analyzed by this Rapporteur and by Committee member William Cornish prior to the Court's decision. See Frederick M. Abbott and D.W. Feer Verkade, *The Silhouette of a Trojan Horse: Reflections on the Advocate General Jacobs' Opinion in Silhouette v. Hartlauer*, *Bijblad bij De Industriële Eigendom* 111, Apr. 16, 1998 and W. R. Cornish, *Trade Marks: Portcullis for the EEA?*, 20 EIPR 172, May 1998.

¹²Limit to trade mark rights, *Times Newspapers Ltd. (London)*, May 24, 1999, Chancery Division, Zino

Silhouette, the holder of a parallel trademark in the United Kingdom could not prevent goods first placed on the market outside the EEA from entering the UK when consent to such importation had been given either expressly or by implication, having regard to all relevant circumstances. These circumstances would include the nature of the goods, the circumstances under which they were put on the market, the terms of the sale contract and the provisions of any relevant law. If the law of the country where goods were first placed on the market established a rebuttable presumption that goods were sold free and clear of restrictions on export, and there was no express agreement to rebut that presumption, then the English courts would allow parallel importation.¹³ The Court noted that further commercialization of goods might be prevented where the physical or material condition of goods was modified in a substantial way without the consent of the trademark holder, to be determined as a matter of fact by the EU member state courts.

Following the ECJ's *Silhouette* decision a number of French lower court decisions have supported the right of EU trademark holders to block parallel importation of consumer products.¹⁴

On December 7, 1999, the Swiss Federal Supreme Court in *Kodak SA v. Jumbo-Markt AG*, 4C.24/1999/rnd, ruled that Switzerland would retain a doctrine of national exhaustion in the field of patents. The Court said that Swiss patent law had traditionally been understood to provide only for national exhaustion, and that in the absence of other direction from the legislature, it would follow this view.¹⁵ The Court recognized that its earlier decisions in favor of

Davidoff SA v. A & G Imports Ltd., before Mr. Justice Laddie (Judgment May 18)(Lexis-Nexis News database).

¹³According to the press report of the decision, "It seemed to his Lordship that *Silhouette* had bestowed on a trade mark owner a parasitic right to interfere with the distribution of goods which bore little or no relationship to the proper function of the trade mark right. It was difficult to believe that a properly informed legislature intended such a result." *Id.*

¹⁴ [Insert citation for French "Levi Jeans" decision.]

¹⁵ The Federal Court said:

10.- Zusammenfassend ist festzuhalten, dass die Frage der nationalen oder internationalen Erschöpfung im schweizerischen Patentrecht nicht geregelt ist, so dass das Gericht gemäss Art. 1 Abs. 2 ZBG anstelle des Gesetzgebers zu entscheiden hat. Die traditionelle schweizerische Auffassung geht für das Patentrecht von der nationalen Erschöpfung aus (oben E. 5). Die Unterschiede zwischen Marken- und Urheberrecht auf der einen und dem Patentrecht auf der anderen Seite lassen eine einheitliche Behandlung der Erschöpfungsfrage nicht als zwingend erscheinen (oben E. 6).

[In summary it is clear that the question of national or international exhaustion in Swiss patent law is not expressly regulated, so that the Court under Art. 1, para. 2, ZBG, in place of the legislature, should decide. The traditional Swiss view goes to national exhaustion of the patent right (sec. 5 above). The difference between trademark and copyright on one side, and the patent right on the other side, leaves an apparent lack of consistent treatment of the exhaustion question

international exhaustion for trademarks and copyrights would leave a Swiss system of differential treatment of the exhaustion question, but considered that the different functions of the forms of IPRs might – in the consideration of the Swiss legislature – allow this result.

B. Actions of Governments

National and regional governments have also acted in relation to the parallel imports issue since the completion of the First Report.

Australia and New Zealand have each adopted legislation permitting parallel importation of works protected by copyright. The legislation adopted by Australia distinguishes among different types of copyrighted works. The Australian and New Zealand legislation was reported on at the November 1998 meeting, and is discussed further *infra*.¹⁶ In the case of New Zealand, at least, this action led to a diplomatic protest by the U.S. government.¹⁷ In June 2000, the government of Australia announced, following the recommendation of its Intellectual Property and Competition Review Committee, that it would further liberalize its rule of international exhaustion in the field of copyright by eliminating a requirement that importers await the Australian copyright holder's release of the work on the local market.¹⁸

The European Commission, at the request of the Council, undertook to study the issue of the exhaustion of trademark rights and to make a report to the Council in June 1999. The governments of Denmark, Ireland, Sweden and the United Kingdom,¹⁹ as well as the

(sec. 6 above.) [Rapporteur's translation]

¹⁶See Chris Creswell, *Recent Developments in Australia and New Zealand*, paper furnished following Committee meeting of November 6-7, 1998, attached as Annex 4. See also, Abraham Van Melle, *Parallel Importing in New Zealand: Historical Origins, Recent Developments, and Future Directions*, [1999] EIPR 63.

¹⁷See, e.g., Gwen Robinson, *Parallel Imports: US warns as New Zealand lifts ban*, FT World, FT.com (Financial Times), May 20, 1998, reporting on statements of USTR Charlene Barshefsky and US Ambassador to New Zealand, Josiah Beeman, in connection with New Zealand's adoption of legislation permitting parallel imports, and response of New Zealand's Prime Minister, Jenny Shipley.

¹⁸See Fourteenth Copyright Newsletter of the Intellectual Property Branch of the Attorney-General's Department, http://law.gov.au/copyright_eneews, June 29, 2000:

The Government announced on 27 June 2000 that it will amend the Copyright Act 1968 to allow for parallel importation of legitimately produced books, periodicals, printed music, and software products including computer-based games. When implemented, this decision will remove the legal impediment imposed by the Copyright Act on Australian importers obtaining these products and making them available to consumers as soon as they are released anywhere in the world. They will not be obliged to wait for the Australian copyright owners to release them in Australia.

¹⁹Several EU member state governments, including those of the United Kingdom, Denmark and Sweden have commenced and/or completed studies of the international exhaustion issue. See, e.g., *Parallel Imports Debate Simmers In Wake Of EU Report*, BILLBOARD, Mar. 13, 1999 (Lexis-Nexis News

Commission, were initially reported to strongly endorse moving toward a rule of international exhaustion.²⁰ France and Germany were reported as the only governments to support maintaining the *Silhouette* rule, although there were reports that even the German government might be reconsidering its position.²¹ The Commission contracted for the preparation of a study by NERA, S J Berwin & Co and IFF Research on the economic consequences of various trademark exhaustion regimes for the EU. This study was completed and is discussed below.²²

On June 7, 2000, the Internal Market Commissioner Frits Bolkestein announced that the Commission had decided against recommending a change to the rule of regional exhaustion in the field of trademarks.²³ The Commission's action was supported by four member states (Austria, France, Italy and Spain), and opposed by eight states (Belgium, Denmark, Finland, Ireland, Luxembourg, the Netherlands, Sweden, and the U.K.), with three states not stating an opinion (Germany, Greece and Portugal).²⁴ The Swedish government has indicated its intention to again take up this question when it assumes the rotating presidency of the Council at the start of 2001.²⁵

The EU Commission refers to the NERA Report in support of the proposition that adoption of a rule of international exhaustion in the field of trademarks would have only marginal effects on pricing or employment in the EU. Yet, as discussed below, the NERA Report is seriously flawed. In addition, the NERA Report does not meaningfully address the role of parallel trade in the prevention of anticompetitive conduct. Since the inception of the Community, this role has been a principal motivation for the intra-Community exhaustion rule.²⁶ The Commission states that since products may be protected by more than one form of IPR, the adoption of international exhaustion for trademarks, but not copyrights or patents, would have only a limited effect. Yet trademarks are far more prevalent than patents, and the use of copyright

database).

²⁰*EU Regulations: Battle over grey Imports*, ECONOMIST INTELLIGENCE UNIT, Mar. 12, 1999 (Lexis-Nexis News database).

²¹*Id.*, and *see also* [cite from Frankfurter Allgemein].

²²A hearing on this report and the subject of exhaustion in the field of trademarks was held by the Commission on April 28 in Brussels. In this connection, *see* Fax memorandum from Committee member Jacques H.J. Bourgeois, and Hartmut Johannes, to the European Commission, DG XV (International Market and Financial Services, Industrial Property), dated April 26, 1999, attached as Annex 5.

²³Communique from Commissioner Bolkestein the issue of exhaustion of trademark rights, June 7, 2000, http://europa.eu.int/comm/internal_market/en/intprop/indprop/comexhaust.htm (visited July 13, 2000).

²⁴*See, id.*, and Kai R. Lofthus, *Eu Tackles Industry Issues: Parallel Imports Ban Stands*, BILLBOARD, June 10, 2000 (Lexis/Nexis database).

²⁵*See* Deborah Hargreaves, *Brussels urged to change rules on trademarks*, FIN. TIMES, June 2, 2000, at 8.

²⁶*See, e.g.*, *Consten and Grundig v. Commission*, Cases 56, 58/64, [1966] ECR 299.

to inhibit the movement of non-expressive works is not permitted by EU law. The Commission states that the adoption of different rules in the First Trade Marks Directive and Community Trade Mark Regulation would create confusion in the market and among consumers, and that it has doubts that unanimity could be reached in the Council to alter the Regulation. This rationale belies independence of the Commission. Finally, the Commission states that a rule of international exhaustion in trademarks “would make it more difficult for EC firms to sell at a lower price outside the Community”. The Commission should offer an explanation as to why it is not interested in promoting lower prices within the Community.

The United States government has begun an inter-agency review of policy regarding parallel importation.²⁷ This review appears to be directed at reconciling policy differences between the U.S. Treasury Department which has traditionally favored international exhaustion, and the US Trade Representative which recently has objected to international exhaustion, at least in respect to copyrights and patents.²⁸ In 1999 the U.S. Treasury Department adopted so-called “Lever-rules” which permit the blocking of parallel import trademarked goods which are materially different from identically-marked goods marketed in the United States, *unless* the importer places a conspicuous notice on the goods indicating that they are materially different, in which case such goods *may* be parallel imported.²⁹

In connection with the WTO Seattle Ministerial Conference, USTR announced that it would hereafter consult with the U.S. Secretary for Health and Human Services regarding claims by trading partners that U.S. intellectual property policies are impeding their ability to address health crises, and “give full weight to the advice of HHS regarding the health considerations involved.”³⁰ In connection with this announcement, USTR removed South Africa from its

²⁷This Rapporteur has been involved in preliminary discussions regarding this review.

²⁸The Rapporteur’s discussions with persons at USTR responsible in this area suggest that there may be some differentiation in position as between the forms of IPR. It should be pointed out, however, that as of this date there has been no systematic analysis of exhaustion/parallel imports issues prepared by USTR.

²⁹*See, e.g.,* Jack Lucentini, *US makers fear flood of “gray market” goods*, J. OF COMM., Mar. 22, 1999, at 1. Under newly adopted regulations, U.S. trademark holders may notify the Customs Service of goods which are claimed to embody “physical and material differences between the specific articles authorized for importation or sale in the United States and those not so authorized.” (19 CFR § 133.2 (e) (“Lever-rule’ protection”). Supporting evidence must be provided. The Customs Service will prohibit importation of “gray market” goods produced by commonly controlled enterprises which it has determined to be physically or materially different (19 CFR § 133.23(a)(3)); *unless* such goods or their packaging “bears a conspicuous and legible label designed to remain on the product until the first point of sale to a retail consumer in the United States stating that: ‘This product is not a product authorized by the United States trademark owner for importation and is physically and materially different from the authorized product.’ The label must be in close proximity to the trademark as it appears in its most prominent location on the article itself or the retail package or container....” (19 CFR § 133.23 (b)).

³⁰Office of the USTR, *The Protection of Intellectual Property and Health Policy*, Press Release 99-97, Dec. 1, 1999.

“Special 301” watch list.³¹ This announcement followed USTR’s decision, under pressure from Vice President Gore, to reduce pressure on South Africa because of its liberal parallel trade and compulsory licensing activities in respect to addressing the AIDS pandemic.³²

C. Research and Analysis

1. The NERA Report³³

The NERA Report for the European Union undertakes to examine the economic role of parallel trade (imports and exports) in trademarked goods for the EU, and the likely consequences of changes in the regime of intra-Union exhaustion in favor of international exhaustion. The Report considers two principal scenarios: one in which the EU unilaterally adopts a rule of international exhaustion and one in which it negotiates reciprocally agreed international exhaustion regimes with the United States and Japan. The Report focuses on ten classes of trademarked goods. It concludes on the whole that either scenario of international exhaustion would result in modest increases in parallel trade for the EU, that prices to consumers would be modestly reduced, that EU producer profits would be moderately adversely affected, and that a modest rise in EU employment would likely occur. The Report suggests that an international exhaustion regime in trademarked goods might adversely affect consumers through reduced services from retailers vertically tied to manufacturers.

Although the NERA Report is of interest for its attempts to quantify the parallel imports issue in respect to the EU, the methodology of the Report raises significant questions about its utility from a policy-making standpoint. Much of the economic analysis is based on the results of surveys undertaken among various interested groups. There was an extremely low response rate to the surveys. Among those who responded, the economic information supplied is acknowledged to be preponderantly of the “best guess” variety. Pricing data is taken from secondary sources which are too general to provide a concrete basis for analysis. The economic analysis is entirely static; suggestions as to dynamic impacts are made on the basis of survey respondent information. Of particular concern is that the Report suggests the possibility of adverse effects on consumers, but provides no empirical data to support this, while prior investigation of consumer injury in consequence of parallel imports has not found adverse effects in fact on consumers.³⁴ The NERA Report gives minimal attention to competitive markets aspects of the parallel imports issue.

³¹*Id.*

³²*See*, Carlos M. Correa, *Integrating Public Health In Patent Legislation In Developing Countries*, paper presented at Rockefeller Foundation, draft of Jan. 30, 2000, at sec. 7.3. Frances Williams, *US to consider poor countries' need for drugs*, FIN. TIMES, Dec. 3, 1999, at 6; Sabin Russell, *Poor Nations Given Hope on AIDS Drugs*, S.F. CHRON., Dec. 3, 1999, at A20.

³³This report is available to download at [www....]. The *Executive Summary* is attached as Annex 6.

³⁴*See* Hilke’s discussion of US Federal Trade Commission investigation, First Report, at 629. *See also*, Maskus and Chen references to US FTC investigation.

Perhaps the most striking aspect of this NERA Report is its indication that intra-EU retail prices for identical products vary widely among member state markets, and that parallel trade is not taking place to arbitrage these price differences. This appears to raise serious questions about whether the EU is indeed approaching the status of a “single market” even with a rule of intra-Union exhaustion. This may suggest that manufacturers’ vertical restraints are effective in preventing the transborder flow of goods even within an “integrated” market. This may add impetus to the activities of the ITLC in regard to trade-related aspects of competition law.

2. Maskus and Chen Research

Leading international trade and IPRs economists, Keith Maskus and Yongmin Chen, undertook to examine the economic impact of parallel trade, with special reference to the pharmaceutical sector. In an initial report,³⁵ Maskus and Chen confirm the unavailability of reliable data upon which to base an empirical analysis of the economic implications of parallel imports. For this reason, Maskus and Chen stress that their present study is largely “game-theoretical”, and that they continue to seek empirical data.

Maskus and Chen have constructed a model of the possible implications of parallel trade. Fundamental points made by Maskus and Chen are: (1) the extent to which parallel trade improves economic welfare may depend on the level of trade barriers in place between importing and exporting countries (2) as trade barriers are reduced, the benefits of parallel trade increase, and (3) parallel trade may reduce economic welfare if and as manufacturers engage in strategic pricing behaviors designed to eliminate such trade, for example by raising *ex manufacturer* prices in countries of production. Manufacturers have lower capacity to engage in such strategic behaviors in competitive markets.

In discussion with this Rapporteur, Maskus noted that the present game theory model is “static” and that it does not account for medium-to-long term changes to the environment in which parallel trade may take place as markets are opened or closed to such trade. For example, the model does not consider whether manufacturers who might raise prices in response to parallel trade may be inhibited from doing so as a consequence of the threat of increased inter-brand trade.³⁶ As did Maleug and Schwartz,³⁷ and as has Carsten Fink,³⁸ Maskus and Chen raise

³⁵Keith E. Maskus and Yongmin Chen, *Vertical Price Control and Parallel Imports*, paper prepared for the joint NBER-ISIT International Trade Seminar, June 4-5, 1999, attached as Annex 7.

³⁶Maskus and Chen have preliminarily suggested that governments, for the time being, adopt a “rule of reason approach” with respect to parallel trade. By this they mean that governments should consider the costs and benefits of parallel trade in the context of their particular circumstances. Maskus has confirmed that reference to rule of reason in this context is used to refer to a mode of economic analysis, and is not intended to refer to a policy preference for a competition law approach to parallel trade issues. Maskus has also cautioned that the suggestions in this paper are preliminary, and should be treated as such.

³⁷See discussion in First Report, at note 40.

³⁸See *infra* text at note [].

the question whether from an economic welfare standpoint there may be optimal exhaustion areas such as integrated regions.³⁹

3. Others

On June 14, 1999 this Rapporteur made a presentation at an UNCTAD seminar in Geneva regarding developmental issues in connection with the exhaustion of rights and parallel importation, and there is some indication that UNCTAD may initiate a research program in this area.⁴⁰ The World Health Organization is considering the implications of exhaustion policies on the supply of pharmaceuticals to developing countries. In addition to the research the European Commission is undertaking with respect to exhaustion and trademarked goods, the Commission has also been studying the role of parallel imports in the pharmaceuticals sector.⁴¹ Certain other research papers will be mentioned in connection with the substantive discussion that follows.

III. Rapporteur's Responses to Reactions to First Report

Prior to the November 1998 Geneva meeting, this Rapporteur prepared and circulated a Discussion Paper.⁴² In that Discussion Paper, this Rapporteur responded to certain critical reactions to the First Report. A few extracts from that Discussion Paper are reproduced here:

A. Emergence of the Exhaustion of Rights Issue

The emergence of the exhaustion of intellectual property rights issue as an item on the world economic agenda reflects a shift in the character of the world economic system evidenced by the conclusion of the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). The value of goods and services in world trade has increasingly been defined by their technology and/or creativity component. The rate of return on investment of the business enterprise has increasingly been defined by the extent to which the enterprise is able to capture the added value of investments in research and development, and creative expression.

The GATT 1947 reflected prevailing wisdom concerning the optimal mechanism for achieving worldwide economic growth. This wisdom traced back to the works of Adam Smith

³⁹Maskus and Chen, at page 25.

⁴⁰Frederick Abbott, *Proposals for an UNCTAD Research Agenda*, Pre-UNCTAD X Seminar on the Role of Competition Policy for Development in Globalizing World Markets, Panel on Competition, IPRs and Transfer of Technology, June 14, 1999 (Geneva).

⁴¹Remarks by Thomas Cueni concerning work program of Internal Markets Directorate at November 1998 meeting.

⁴²Frederick M. Abbott, *Discussion Paper for Conference on Exhaustion of Intellectual Property Rights and Parallel Importation in World Trade*, Geneva, Nov. 6-7, 1998, Committee on International Trade Law, attached as Annex 8.

and David Ricardo, and was reaffirmed in works by the architects of the Bretton Woods system of economic institutions. The removal of barriers to trade in goods among nations would result in the efficient allocation of productive resources on a worldwide level. All nations that participated in this system of liberal trade would benefit from this efficient allocation (although the distribution of benefits would depend on the characteristics of individual nations). The period from the inception of the GATT 1947 until the entry into force of the WTO Agreement witnessed sustained growth in the level of world trade, and sustained overall economic growth in the world economic system.

The WTO Agreement of 1995 reflected changing world economic circumstances. First, as the proportion of world trade flows made up of services continued to expand, it was no longer adequate for the GATT to concern itself only with trade in goods. The conclusion of the General Agreement on Trade in Services (GATS) accommodated the growing role of services trade in the world economy. Second, as the value of goods and services were increasingly defined by technology and expression components, it became important to accord those components legal protection. The TRIPS Agreement was designed to assure an adequate level of legal protection for the technology and expression components of goods and services in world trade.

The exhaustion of intellectual property rights (IPRs) issue concerns the extent to which holders of IPRs may invoke those rights to inhibit the movement of goods and services among nations and regions. At its foundation, the exhaustion of rights issue involves a profound claim by the holders of IPRs. This claim is that the value of protecting intellectual property at the national and regional level exceeds the value to the world economic system of open trade among nations and regions. This claim or proposition is a serious one. It appears to be based on the notion of a quantum shift in the basic character of the global economy.

Limitations in tools of economic analysis of the value of IPRs protection, as well as limitations in data collection, make it difficult to evaluate the merits of this claim as a matter of hard science. Because of comparatively recent shifts in the characteristics of the world economy, the historical record regarding the impact of national and regional rules with respect to exhaustion of IPRs may not provide adequate insight into the impact of such rules in the post-TRIPS Agreement environment. The specific interests of developed and developing countries in the exhaustion of rights question may not be coincident, viewed either from an historical or future orientation.

Framing the foundation of the exhaustion issue broadly should not obscure the many levels of complexity and detail which must go into addressing it. There are various kinds of intellectual property, and the economic and social values associated with some forms of protection differ from the values associated with other forms. There are competitive market aspects to the question which may be roughly framed in terms of the distinction between inter-brand and intra-brand effects on competition which may be relevant to addressing the issue.

IPRs-related issues are often conjoined with other regulatory issues in the analysis of exhaustion rules. It is important that these issues be properly disaggregated in the framework of inquiry.

B. Critiques of the Premise

The initial premise of the First Report has been critiqued on two grounds. The first critique argues that the WTO Agreement by its terms and spirit does not favor liberal trade over protection of intellectual property, so that analysis of the exhaustion issue should not proceed from a presumption in favor of liberal trade, but rather from a presumption of treating IPRs protection and liberal trade on equal ground. The second critique argues that in the pre-TRIPS Agreement environment a number of GATT members maintained legislation precluding parallel imports so that, if the international economic system was functioning well prior to the TRIPS Agreement, it should be assumed that inhibition of parallel imports does not have adverse effects.

1. Response to textual critique

On a textual basis, the WTO Agreement does not establish an equivalence between the objectives of removing barriers to trade and the protection of IPRs.⁴³ The preamble of the WTO Agreement states that the parties undertake their legal obligations:

Recognizing that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing for the optimal use of the world's resources in accordance with the objective of sustainable development, ...

Recognizing further that there is need for positive efforts designed to ensure that developing countries, and especially the least developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development, [and]

Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations,⁴⁴

The preamble elucidates the goal of raising worldwide standards of living, with special attention to the developing countries, through the strategy of trade liberalization.⁴⁵

⁴³ For an alternative, see Marco C.E.J. Bronckers, *The Exhaustion of Patent Rights in the WTO*, see *infra* note 74, (referring to the view of this author, stating, *e.g.*, “as a matter of principle, one may ask whether *any* issue of intellectual property protection can still be tackled or attacked on the basis of other WTO rules, notably the GATT’s principles.”)

⁴⁴ Agreement Establishing the World Trade Organization, at preamble.

⁴⁵ There is no reference to IPRs in the WTO Agreement preamble.

In adopting the TRIPS Agreement, WTO Members framed the role of IPRs protection within the overall WTO trade-centered strategy for economic growth. Members undertook to establish new rules and disciplines concerning IPRs:

Desiring to reduce distortions and impediments to international trade, and taking into account the need to promote effective and adequate protection of intellectual property rights, and to ensure that measures and procedures to enforce intellectual property rights do not themselves become barriers to legitimate trade; [underlining added]⁴⁶

The TRIPS Agreement was added to the GATT -- now WTO -- framework to assure that adequate protection of IPRs promoted world trade in goods and services; and that the under- and over-protection of IPRs did not undermine the economic strategy and ultimate objectives of the organization. The protection of IPRs is part of the means to an end -- to be taken into account@ within a larger strategy to promote economic growth.

The foregoing references to the text of the WTO Agreement are not intended to suggest that WTO members fail to regard the protection of IPRs as important. Conclusion of the TRIPS Agreement indicates that members place a significant positive value on the encouragement of invention and on creative expression. However, in light of the inherent tension between IPRs-based territorial restrictions and the rules of the GATT 1994 and GATS promoting the free movement of goods and services, it may be necessary to give priority to one set of values over the other. It is suggested here that the WTO Agreement places a priority on the liberalization of markets – and that a presumption in that direction, as opposed to strict neutrality or a converse presumption, is appropriate.⁴⁷

2. Response to the historical critique

A second critique as to the premise of the First Report questions whether it would not be most appropriate to assume that the pre-TRIPS historical situation regarding the application of exhaustion rules is the proper “default situation” (that is, the situation that should remain in place) absent any concrete basis for altering this pre-existing situation. If the world trading system operated successfully in the pre-TRIPS Agreement environment, and if that system included GATT members that blocked parallel imports, why not start with the presumption that rules restricting parallel importation are appropriate?

There are a number of responses to this observation.

First, while a number of GATT members may have blocked parallel imports in some

⁴⁶Agreement on Trade-Related Aspects of Intellectual Property Rights, at preamble.

⁴⁷There are additional issues pertaining to the exhaustion of rights question involving the relationship between the TRIPS Agreement, and in particular Article 6, and other WTO Agreements, and in particular the GATT 1994. *See infra* this Second Report, text at notes [].

IPRs fields prior to the TRIPS Agreement, the legal situation regarding parallel imports has been rather mixed even in respect to some countries and regions that now express some disfavor for parallel imports. The United States Treasury Department advocated an open parallel imports market in trademarked goods for decades; U.S. legislation and regulations broadly allowed parallel imports of trademarked goods until the Supreme Court's *K mart* decision in 1987,⁴⁸ and the *K mart* decision continued to allow parallel imports in the situation of commonly controlled enterprises. U.S. case law largely favors international exhaustion in the field of patents, while allowing patent holders some measure of control by means of license.⁴⁹ Japan has long permitted parallel imports of trademarked goods. Germany and other EU members (e.g., Austria, Finland, the Netherlands, Sweden and the UK (the latter under a common control doctrine)) followed rules of international exhaustion in respect to trademarked goods (prior to the Trade Marks Directive and the subsequent *Silhouette* decision).⁵⁰ If the suggestion is that the pre-TRIPS Agreement trading system was one in which members broadly restricted parallel imports, this is not factually accurate. What might accurately be said is that prior to the TRIPS Agreement GATT members followed a number of different (and often subtly different) approaches with respect to parallel imports.⁵¹

Second, even if it is assumed solely for the sake of argument that the pre-existing situation was one in which parallel importation was widely blocked, it does not follow that the outcome was optimal. While there has been a strong pattern of trade and economic growth in the world economy since the inception of the GATT 1947, the developing countries have not made the kind of economic progress that would be desirable. The developing countries have lagged in local capital formation (being reliant on foreign direct investment) and have lagged in establishing technology-based industries competitive with those of the OECD countries. The First Report suggests that rules blocking parallel imports disadvantage the developing countries as their national enterprises are restricted in taking advantage of export opportunities. To what extent have rules restricting parallel importation adversely affected the developing countries in the past? Has this been a factor contributing to disparities in worldwide patterns of economic development?

Third, the only conclusion to which approval of the historical record might lead is that the rule of TRIPS Agreement Article 6 should remain in place. That is, that a diversity of rules maintained by WTO members should be the ongoing norm. Leaving aside whether it might not be better to seek the most appropriate single rule (or set of rules), there is evidence that some

⁴⁸*K mart Corp. v. Cartier*, 486 U.S. 281 (1987).

⁴⁹See Frederick M. Abbott, *Political Economy of the U.S. Parallel Trade Experience: Toward a More Thoughtful Policy*, in 3 WORLD TRADE FORUM, Ch. 12 (T. Cottier and P. Mavroidis eds. 2000).

⁵⁰The European Union has virtually since its inception followed an intra-Union rule of exhaustion across all forms of IPR. EU internal policy on parallel imports issues is described and analyzed in the First Report. [Subsequent to preparation of Discussion Paper, see Baudenbacher, *supra* note 5, for discussion of member state exhaustion policies prior to First Trade Marks Directive and *Silhouette* decision.]

⁵¹See First Report, at 611, for discussion of these rules.

members of the WTO are not prepared to tolerate this situation from a political standpoint. At least until quite recently, the United States government has indicated that it considers the adoption of open policies on parallel importation as against U.S. interests.

Finally, it seems evident that business enterprises are increasing their focus on intellectual property rights protection issues. New IPRs protection laws are being put into place in WTO members around the world. In the post-TRIPS Agreement environment, the risk seems to rise appreciably that IPRs will be invoked to block the movement of goods and services among nations and regions. This should cause some hesitation toward reliance on the historical record.

3. Critiques on Economic Grounds

The First Report accepts that the pursuit of liberal trade policy is the best available mechanism for enhancing worldwide standards of living. Liberal trade policy is based on the theory of comparative advantage.⁵² This theory posits that the exchange of goods and services on an open market results in nations specializing in the production of goods and services in which they are comparatively the most efficient. This specialization enhances global productivity and produces benefits for all world market participants.

The theory of comparative advantage operates on the basis of price. Each nation produces goods and services whose domestic price reflects the cost of its various factors of production. If the price of a good in one market is less than the price of the same good in another market, traders will move goods from the lower priced market to the higher priced market. Producers in the lower priced market will shift away from comparatively less efficient areas of production and into more efficient and competitive areas of production, and national and global productivity will increase. The GATT-WTO trading system accepts that the greatest level of global productivity increase occurs when tariff and non-tariff barriers are reduced so as to allow low cost producers to sell across the widest possible market, and thereby to maximize production efficiencies.

Rules restricting parallel imports are non-tariff barriers to trade (in effect, quotas). Quotas were prohibited by the GATT 1947, and they are prohibited by the GATT 1994. Quotas are antithetical to the operation of comparative advantage because they prevent the movement of goods and services which is necessary for a preferred allocation of productive resources.

4. International Price Discrimination

Advocates of rules restricting parallel imports have not directly quarreled with the theory of comparative advantage or the idea that quotas are antithetical to enhancing global productivity. Some, however, have sought to justify market segregation by arguing that “international price discrimination” may be global welfare enhancing.

The theory of beneficial price discrimination runs as follows: Consumers in different

⁵²For an excellent elaboration of this theory, see Alan O. Sykes, *Comparative Advantage and the Normative Economics of International Trade Policy*, 1 JIEL 49 (1998).

markets, for a variety of reasons, are able and willing to pay different prices for different goods and services. A consumer in the United States may be able and willing to pay \$10 for a product, while a consumer in Mexico is able and willing to pay only \$5 for the same product. Assuming that the U.S. producer is able to make and sell the product for \$3, that producer should sell its product in Mexico for \$5 while selling it for \$10 in the United States. The producer will maximize its return on investment by satisfying demand in each nation at the highest price (consistent with maintaining demand). The Mexican consumer will benefit because the product will be affordable when it might otherwise not be. The U.S. consumer appears to lose. However, since the producer's income in Mexico should allow some reduction in its prices over the long run, there is in reality a long term benefit to the U.S. consumer.

Of course, for the U.S. producer to price discriminate as described above, traders must not be allowed to buy the product in Mexico and sell it in the United States. Purchases by traders in Mexico would raise prices there, and exports from Mexico would undercut prices in the United States. In other words, for a price discrimination system to operate, trade needs to be restricted. Rules against parallel imports are intended precisely to accomplish this purpose. That is, these rules are designed to allow producers to charge different prices in different markets without the threat that trade will affect their pricing strategies.

The theory of beneficial price discrimination seems to be fundamentally at odds with the theory of comparative advantage and the underlying economic premise of the GATT-WTO trading system.⁵³ Since quotas are as a general proposition prohibited by the GATT 1994, business enterprises are in general precluded from engaging in overt price discrimination between markets, except to the extent that transport and related costs allow some price differentials to exist.

Why should not the GATT-WTO system encourage price discrimination?

A producer earns the right to sell in the worldwide market by lowering its costs of production to the point at which it is able to sell (worldwide) at a profit. Take the case of the U.S. producer just described. That producer is not pressured to lower its costs of production in the United States because it is not facing competition from low cost imports from Mexico (even imports from its own factories). If the domestic producer can produce and sell in its home market at a high price, while relegating its surplus (marginal) production and sales to foreign markets, it will not face equivalent pressure to lower costs.⁵⁴ This absence of pressure to reduce costs has a negative overall effect on global production efficiency.

But, argue those in favor of international price discrimination, the U.S. producer will nevertheless face competition from other producers of the same product (or similar substitute products). The producer will not survive in the U.S. market while selling its product at \$10 if it is

⁵³The United States (as example) has long criticized the Japanese government for tolerating the sale of products in the Japanese market at prices above those charged in the U.S. market.

⁵⁴The pressure to lower costs may, for example, induce the producer to shift a larger proportion of its production to Mexico.

possible to produce and sell the same product at \$5 (as it does in Mexico), since there will be other U.S. and foreign producers who will enter and capture its market share. Therefore, it is argued, the U.S. producer must always seek to lower its prices regardless of international trade rules.

The claim that inter-firm competition will assure competitive pricing and production efficiencies does not adequately account for imperfectly competitive structures in national and regional markets. When producers in national and regional markets are insulated from external competition (*i.e.* insulated from imports), the risks of collusive pricing strategies and the tolerance of economic inefficiencies are substantially heightened.⁵⁵ There are significant risks that groups of producers who sell in single markets will agree to restrict output and maintain prices above market-efficient prices so as collectively to secure non-market rates of return.⁵⁶ By opening national and regional markets to trade, governments substantially reduce the risks posed by imperfect national and regional market structures.

The GATT 1994 clearly prohibits governments from imposing quotas that would prevent traders from equalizing prices among markets.⁵⁷

a. Harm to development interests

The First Report suggested that if developing country enterprises must compete with low cost sales from industrialized country enterprises, and are restricted in their export opportunities, this will inhibit capital formation and economic growth in the developing countries.

It should be clarified that not all below world market price sales in developing countries would have the same adverse effects on local capital formation. The specific effects will depend

⁵⁵Consider, for example, that a main reason why the WTO moved to eliminate voluntary export restraints and orderly marketing arrangements (VERs and OMAs) was that such arrangements adversely affected consumers by reducing incentives in protected markets to enhance efficiency and lower prices.

⁵⁶This is analogous to an argument in U.S. competition law in respect to minimum resale price maintenance. Producers have long sought to persuade the Supreme Court that they should be able to set resale prices among their authorized resellers because the producers inevitably face price competition from other producers, and so are effectively pressured to lower prices. The Supreme Court has rejected this argument, saying that when producers are allowed to determine the resale prices of their products, serious risk of collusive – or cartel-like – behavior arises. *See, e.g., Business Electronics v. Sharp Electronics*, 485 U.S. 717, 724 (1988), where the Court observed that vertical agreements on resale prices have been illegal *per se* since 1911. The Court said that vertical price restraints may reduce inter-brand price competition by facilitating cartelization. *Id.* at 725-26. In the *Quality King v. L'anza* decision, *supra*, the U.S. Supreme Court expressed considerable skepticism toward allowing IPRs to be used to enforce international price discrimination.

⁵⁷As noted in the First Report, producers are entitled to allocate primary distribution territories by contract. Whether a producer is entitled to fix the first sale prices of its distributors is regulated by competition law. In the United States and the EU, resale price maintenance is prohibited by competition law.

on the character of the local economy, just as the effects of lower than world market price sales in industrialized countries have different effects depending on the characteristics of the local economy. In some cases, the effect of such sales may be to prevent a competitor from emerging or remaining in business. In other cases the result may be more diffuse – affecting consumer and producer decisions as to other products or services.⁵⁸

b. International price discrimination based on IPRs

Holders of IPRs who favor restricting parallel imports based on claims regarding international price discrimination are not arguing for a general WTO rule to permit such discrimination. They argue that the patent, trademark and copyright justify international price discrimination.

i. Trademark

The economic justifications asserted by trademark holder groups for the use of marks as a basis for restricting imports are described and evaluated in the First Report. The essence of the trademark holder argument is that restrictions on parallel imports enable the segregation of distribution territories. This in turn permits the adoption of market-specific distribution strategies. These strategies include differential advertising, pre- and post-sale service and support, and product differentiation. These differentiated strategies are argued to enhance consumer welfare.

There has been no support among members of the ITLC for the trademark holders position. Trademarks attach to a very high proportion of world trade, and acceptance of the trademark as a basis for market segregation would in effect constitute the adoption of a general WTO-GATT rule in its favor.

ii. Copyright

Copyright holders argue that price discrimination is welfare enhancing since it permits consumers in less affluent markets to purchase products that could not otherwise be purchased. As a corollary to this argument, international price discrimination benefits the producers of copyrighted works because it allows them to maximize returns in each national/regional market

⁵⁸An analogy between low cost sales enabled by restrictions on parallel imports, and the practice of “dumping” (that is, selling for export to a foreign market at a price below the home market) may be suggested. Low priced sales discrimination in the parallel imports context will frequently involve goods produced locally (*i.e.* not imported), so there may be no dumping *per se*. Economists are divided on the question whether dumping is harmful to the international economy. It has often been suggested that if “predatory” dumping (*i.e.* dumping with the intention to harm competitors) could be distinguished from non-predatory dumping (e.g., short term measures needed to reduce inventory), then rules against dumping would be more coherent. Similarly, one might draw some distinction between low cost sales in developing country markets that might have a negative effect in fact on capital formation (and the establishment of industry), and those low cost sales that would have no such adverse impact. Such a distinction would nevertheless not address the diffuse market distorting effects of lower than world market price sales.

and thereby enhances aggregate revenues and profits.

No persuasive evidence has been presented that returns on investment in the copyright-dependent industries (audio-visual, software, etc.) are or will be inadequate to allow future investments in creative expression. Consumer demand in less affluent markets can be met by differentiated products (*e.g.*, translated and soft-bound books). The U.S. Supreme Court observed in its *Quality King v. L'anza* decision that there are a variety of mechanisms by which copyright holders can pursue market differentiation strategies without seeking governmental protection for price discrimination.⁵⁹

The First Report has already addressed the unique characteristics of broadcasts and performances which depend for their economic return on repeated showings.⁶⁰

Unless the WTO is prepared to adopt market segregation as its preferred economic foundation, there is no persuasive basis for accepting the copyright holders' claim in favor of international price discrimination.

iii. Patent

As members of the ITLC have suggested, the patent presents the most interesting and difficult case for evaluation.

Among the IPRs, the patent is generally considered to have the highest potential social welfare enhancing value because the patent relates to technological invention. The presumed benefit of encouraging invention is reflected in the establishment of the patent as a "hard" form of IPR protection. That is, the patent allows the exclusion of independent inventors from the market.

As a general rule, patents are granted following examination of the claimed invention, and patents are subject to post-grant challenge either in opposition proceedings or by assertion of invalidity in infringement actions.⁶¹ On the whole, public policy specialists and governments have placed a higher value on the invention and investment presumed to derive from the grant of patents than on the results encouraged by copyright and trademark.

This presumptive higher economic and social welfare value is at the foundation of two economic claims by patent holders. The first is that international price discrimination should be tolerated in favor of patent holders because the maximization of returns to inventors of new

⁵⁹These strategies include product differentiation.

⁶⁰Copyright holders also argue that rules restricting parallel imports facilitate the prevention of trade in counterfeit goods. The general restriction of trade may well reduce the level of counterfeit/illegal trade, but it will also reduce the level of legitimate trade.

⁶¹Copyright attaches automatically to any independently created expressive work, and the trademark is largely dependent on its absence of conflict with pre-existing marks.

technologies (i.e. patent holders) should be encouraged even at the expense of restriction on trade. The patent holder may be willing to accept that allowing international price discrimination distorts the international allocation of productive resources, but argues that this distortion should be tolerated (or even encouraged) because of the inherent value of invention.

Economic analysis of this argument is difficult for a variety of reasons. There is a serious gap in economic data and analysis which might demonstrate the positive impact of patent protection as claimed by the patent holders. This gap is well known and accepted among IPRs economists and public policy specialists.⁶² Since the value of patents to the international economic system has not been empirically demonstrated, there is no concrete basis for analyzing the trade-off in values that patent holders have suggested.

Another serious question is posed by the fact that patent holdings worldwide are largely in the hands of enterprises based in a small group of industrialized countries. The claim that patent holders should be entitled to “super-returns” based on the value of invention also is a claim that a higher proportion of global wealth should be allocated to industrialized country enterprises. There is an issue whether the developing countries should favor this allocation even if a certain level of additional inventive activity is encouraged.

At the present time, the question whether patents should justify restrictions on parallel imports involves weighing competing values in a situation of substantial indeterminacy.

For this Rapporteur, the economic premise of the GATT 1947 and GATT 1994 – that open markets and trade are the best mechanism for enhancing worldwide standards of living – is more convincing than the arguments in favor of enhancing returns to patent holders. The Rapporteur is particularly concerned to assure that developing country enterprises are enabled to become more competitive with industrialized country enterprises, both at the level of inventiveness and at the level of capital formation.

Conversely, some members of the ITLC place a greater value on increasing returns to patent holders. These members believe that the economic and social welfare value of technological invention exceeds the potential harm to world trade that may flow from restrictions on the free movement of patented goods. They suggest that patent holders should be entitled to maximize their economic returns on a worldwide basis by segregating markets and obtaining the highest return on investment from each market.

(A) The special claim of the pharmaceutical industries

A special claim is made by the pharmaceutical industries in favor of international price discrimination. This claim is that regardless of the general utility of price discrimination, there is a unique justification for price discrimination in favor of satisfying demand in developing

⁶²The current situation in the field of economic analysis is discussed at some length in two papers. See Frederick M. Abbott, *The Enduring Enigma of TRIPS: A Challenge to the World Economic System*, 1 JIEL 497 (1998) and Carlos A. Primo Braga, Carsten Fink and Claudia Paz Sepulveda, *Intellectual Property Rights and Economic Development*, TechNet Working Paper, draft of Oct. 13, 1998.

country drug markets. If pharmaceutical producers face a risk that drugs sold at low prices in developing markets will be exported to industrialized country markets, the producers will be unable (or unwilling) to address legitimate public health interests in the developing countries.⁶³

Developing country markets are in different situations regarding their dependency on industrialized country pharmaceutical suppliers. Where there is a significant indigenous pharmaceutical industry that might satisfy local demand and might be harmed by the availability of lower than world price pharmaceuticals, there may be reason to question whether restrictions on parallel imports would be beneficial in social welfare terms. Moreover, it is important to the welfare of consumers in all countries that developing country pharmaceutical enterprises supply lower-priced products to the world market, and such enterprises may face difficulties in becoming established if they are faced with steady competition from marginal-cost industrialized country products.

As to markets that do not maintain, and are unlikely to develop, competitive local pharmaceutical producing industries, the arguments in favor of restricting exports of below world market price drugs may be compelling. If pharmaceutical producers wish to supply these developing countries with low cost drugs, the public health interest may well exceed the liberal trade interest.

However, the public health justification for encouraging low cost sales and restricting exports in these cases does not justify a broad rule in favor of restricting parallel imports of patented products. Instead, restrictions on exports can be exceptionally justified under GATT Article XX(b) and the public interest safeguards of the TRIPS Agreement (*e.g.*, Article 8:1).

(B) Bundled Public Interest Considerations

Pharmaceutical patent holders have also argued in favor of restrictions on parallel trade in drugs on grounds unrelated to international price discrimination.⁶⁴ The pharmaceutical industries argue that national regulatory systems relating to pharmaceuticals are sufficiently different that open markets in pharmaceutical products are antithetical to the public interest. Producers are subject to different requirements regarding testing, packaging and labeling (disclosure), handling and so forth. Public health authorities in different countries are argued to have difficulty protecting the public interest if pharmaceutical products are allowed to move freely between markets.

This public health line of argumentation should be “unbundled” from intellectual property rights and exhaustion issues. The foregoing kinds of public health concerns are at best tangentially related to patents or to inventiveness. National health care regulations address pharmaceutical products whether they are on-patent or off-patent. Such regulations address the risks inherent in the use of pharmaceuticals.

⁶³*See, e.g.*, Bale, *infra* note 67.

⁶⁴*See, e.g., id.*

If a WTO member is persuaded that national public health is endangered by the free movement of particular pharmaceutical products, restrictions on import may be justified under GATT Article XX(b). If WTO members are persuaded that world public health is put at risk by the movement among nations of pharmaceutical products, perhaps some broader exception from the Article XI prohibition of quotas could be introduced. In any case, these are issues that are more appropriately addressed in the context of the GATT 1994, the Agreement on Sanitary and Phytosanitary Measures (SPS Agreement) and the Agreement on Technical Barriers to Trade (TBT Agreement) than in the context of the exhaustion of IPRs and parallel imports.

IV. Results of the November 1998 Geneva Meeting

A. Report of Presentations and Discussion

The November 1998 special meeting in Geneva provided the opportunity for an exchange of views among members of the Committee, representatives of international organizations and industry groups, and other distinguished experts. Those making formal presentations emphasized these points:

1. Adrian Otten (WTO) - Mr. Otten pointed out that the treatment of exhaustion of rights in the TRIPS Agreement was the subject of difficult and intensive negotiations during the Uruguay Round. The formula in Article 6, TRIPS Agreement, reflects a compromise between governments favoring an explicit recognition of national discretion in regard to exhaustion practices, including the choice of national or international exhaustion, and governments not wanting to provide such recognition although not seeking to regulate such practices specifically. The penultimately proposed formula would have indicated that the TRIPS Agreement did not address the issue of exhaustion of rights, while the final formula indicates that for purposes of dispute settlement under the TRIPS Agreement, nothing in that Agreement (subject to articles 3 and 4) will be used to address the issue of exhaustion. Both sides to the negotiations preferred the final formula. Mr. Otten observed that earlier proposals, on the one hand, for a provision restricting the scope for parallel imports in situations where prices had been influenced by government measures such as price controls and for a specific rule providing rights against parallel imports in the copyright area and, on the other hand, a provision requiring international exhaustion, at least in the trademark area, were rejected during these negotiations. In a subsequent comment from the floor, Mr. Otten indicated that he remains to be convinced that provisions of WTO agreements outside the TRIPS Agreement may not be used to address national laws on the exhaustion of IPRs, where the treatment accorded depends on the geographical origin of the goods rather than the nationality of the persons involved.

2. Phillippe Brusick (UNCTAD) - Mr. Brusick indicated that the subject of exhaustion of rights and implications for developing countries has been the subject of study by UNCTAD for some time. He pointed to specific examples which raised questions concerning whether restrictions on parallel imports might limit the ability of developing country producers to compete in international markets. He indicated that there is some concern among developing countries that they will face pressure from developed countries on this subject, and for that reason a multilateral agreement may be important to settle this “unfinished business” in the TRIPS Agreement. He suggested that one starting point for such an agreement is “The Set of

Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices”, adopted by the UN General Assembly, and particularly Sections D:4(b) & (d) thereof, relating to abuse of dominant position.⁶⁵

3. Carsten Fink (World Bank)⁶⁶ - Mr. Fink approached the exhaustion question from the standpoint of an economist. He suggested that an analysis of the exhaustion question solely from the perspective of inhibition on free trade is inappropriate since intellectual property rights (IPRs) are inherently understood to inhibit competition and establish barriers to market entry. The exhaustion question must therefore be examined in terms of the dynamic impact of IPRs in relation to trade and consumer welfare. Mr. Fink indicated that there are circumstances in which consumers may be better off under a regime which restricts parallel imports, such as when consumers in developing countries benefit from price discrimination in their favor. Producers will generally prefer a regime which restricts parallel imports because the ability to price discriminate will likely enhance revenues. Mr. Fink suggested that analysis of the welfare effects of exhaustion regimes is likely to vary depending on the type of IPR examined, and also cautioned that there is negligible empirical data on which analysis may presently be undertaken. Further analysis might suggest the possibility of “optimal exhaustion zones,” such as regional exhaustion areas.

4. Harvey Bale (International Federation of Pharmaceutical Manufacturers Associations -

⁶⁵The relevant provision states:

D.4. Enterprises should refrain from the following acts or behavior in a relevant market when, through an abuse [as elaborated in a footnote - omitted here] or acquisition and abuse of a dominant position of market power, they limit access to markets or otherwise unduly restrain competition, having or being likely to have adverse effects on international trade, particularly that of developing countries, and on the development of these countries:

...

(b) Discriminatory (i.e. unjustifiably differentiated) pricing or terms or conditions in the supply or purchase of goods or services ...

...

(e) Restrictions on the importation of goods which have been legitimately marked abroad with a trademark identical with or similar to the trademark protected as to identical or similar goods in the importing country where the trademarks in question are of the same origin, i.e. belong to the same owner or are used by enterprises between which there is economic, organizational, managerial or legal interdependence and where the purpose of such restrictions is to maintain artificially high prices;

....

⁶⁶See Carsten Fink, *Does national exhaustion of intellectual property rights contradict the principle of free trade?*, draft of Oct. 1998, for *Conference on Exhaustion of Intellectual Property Rights and Parallel Importation in World Trade*, Geneva, Nov. 6-7, 1998, Committee on International Trade Law, attached as Annex 9.

IFPMA)⁶⁷ - Dr. Bale addressed the exhaustion issue from the standpoint of the multinational pharmaceutical industries. He indicated that price comparisons among markets should be based on comparison of *ex manufacturer* prices rather than retail prices since retail prices are significantly affected by differences in wholesale and pharmacy margins, and by government intervention, including taxation. He emphasized that the pharmaceutical industries are highly dependent on patent protection, and that pharmaceutical prices are distorted by government policies in the form of price controls, in particular, but also in such matters as prohibitions against withdrawal from markets. Dr. Bale suggested that price discrimination is particularly beneficial for developing countries, and that enhancing the ability of pharmaceutical companies to price discriminate in favor of developing countries may be desirable. He also indicated that various public health and safety interests – such as interests in assuring that company tracking systems are effective in recalling products – argue in favor of restricting the free movement of pharmaceuticals.

5. Thomas Cueni (InterPharma) - Dr. Cueni addressed the exhaustion issue from the standpoint of pharmaceutical producers doing business in the European Union. He suggested that price differentials exploited by parallel traders are rarely reflected at the consumer level, i.e. that traders and retailers generally capture price differentials. He focused on the fact that pharmaceutical prices in the EU are heavily regulated, so that producers are operating under distorted market conditions. He indicated that parallel traders operate largely in relation to the most profitable pharmaceutical products, and tend to avoid less profitable products. This means that parallel trade can have an impact on pharmaceutical company profits that exceeds that which would be suggested by a relatively low percentage of products subject to parallel trade. He suggested that consumers are less satisfied with parallel import products because of language differences in packaging and instructions. Dr. Cueni noted that while the ITLC First Report specifically took into account the market distorting impact of price controls, that users of that Report tended to ignore that aspect.

6. Christopher Heath (Max-Planck-Institute, Munich)⁶⁸ - Mr. Heath noted that the Paris Convention on the Protection of Industrial Property incorporates a rule of independence of patents, but that this rule does not imply a corollary rule of “territoriality” of patents. The principle of independence is intended to protect against the arbitrary deprivation of patent rights by national patent authorities, and not to ensure that patent rights are separately exhausted in each national jurisdiction. The TRIPS Agreement right of importation allows patent holders to protect against counterfeit or patent infringing products before they enter into circulation within national territories. Prior to the TRIPS Agreement, patent holders were often required to initiate internal infringement proceedings to contest counterfeit or infringing products. The right of importation is subject to exhaustion just as are other patent rights. Mr. Heath considers that patent rights should be exhausted only if a product is placed on a market in which a patent right is held (i.e. there should be a right to market once under monopoly conditions), so that a first sale

⁶⁷See Harvey E. Bale, Jr., *The Conflicts Between Parallel Trade and Product Access and Innovation: The Case of Pharmaceuticals*, 1 JIEL 637 (1999), attached as Annex 10.

⁶⁸See Christopher Heath, *Parallel Imports and International Trade*, 28 IIC 623 (1997), attached as Annex 11.

in a market where a patent is not held should not result in exhaustion with respect to that product. Mr. Heath concurs that price controls on pharmaceutical products distort free trade conditions so that parallel imports might be excluded from countries with price controls. Low price sales of pharmaceuticals in developing countries are a form of subsidization from high price countries. Subsidies are a questionable policy instrument.

7. Eric Smith (International Intellectual Property Alliance - IIPA) - Mr. Smith introduced a series of speakers representing various segments of the copyright industries. He observed that the copyright industries represent approximately a \$280 billion contribution to U.S. GDP, are growing at twice the rate of the U.S. economy as a whole, employ workers at three times the rate of the U.S. economy as a whole, and lead the automobile and agriculture industries in export sales. He noted that there is limited empirical evidence upon which to evaluate parallel trade issues. He also observed that the First Report of the ITLC had stimulated the IIPA to pursue a systematic analysis of parallel trade issues. He distributed a preliminary list of countries with indication of their parallel import policy in respect to copyright, requesting that meeting participants provide further information as might be warranted.⁶⁹

8. Claude Barfield (American Enterprise Institute)⁷⁰ - Mr. Barfield indicated that the liberal trade model of Adam Smith which underlies the GATT-WTO must be re-evaluated in light of changes to the world economy. Intellectual property is an important component of comparative advantage, and producers should be permitted to exploit IPRs to maximize their advantages. The idea that perfect competition in markets is the most desirable means for creating economic efficiency has been replaced by the idea that the exercise of market power yields maximum economic welfare. Producers view world markets in terms of trade and investment. Copyrights permit producers to segment markets, and this is beneficial because it allows them to maximize their returns on investment. This in turn permits additional investments in creativity. Copyrighted works have public goods aspects which need to be accounted for in their regulation.

9. Mark Groombridge (American Enterprise Institute)⁷¹ - Mr. Groombridge indicated that he would address the issue of whether rules restricting parallel importation are beneficial from the standpoint of the competition law treatment of vertical restraints. In his view, which is supported by the work of Robert Bork, vertical restraints may enhance competition by increasing the market power of individual enterprises, and thereby foster inter-brand competition. Restrictions on parallel imports in the field of copyright (i.e. enforced territoriality) are essentially a policy mechanism to protect vertical sales restraints. He suggests that "abusive" price discrimination is generally not sustainable because it creates opportunities for inter-brand competition. Mr. Groombridge accepts that vertical restraints may provide an environment supportive of horizontal collusion and price fixing, but suggests that the defense against such misconduct is

⁶⁹See Parallel Import Protection in 107 Selected Countries, International Intellectual Property Alliance, attached as Annex 12.

⁷⁰See Claude E. Barfield and Mark A. Groombridge, *The economic case for copyright owner control over parallel imports*, J. OF WORLD INTELL. PROP. 903 (1998), attached as Annex 13.

⁷¹See also, *id.*

application of competition laws. He appreciates the suggestion in the First Report that private contracts may be used to regulate vertical distribution relationships in a way that is less trade distorting than restrictions on parallel imports, but concludes that contracts are not enforceable in many environments so that border measures are needed to enforce vertical restraints at the international level.

10. Dara McGreevy (Motion Picture Association) - Mr. McGreevy stressed two points regarding the interests of the motion picture industry and parallel imports. The first is that the industry is built up around the sequential distribution of films, both in the theatrical and home video sectors. The early appearance of a home video or DVD (even if a legitimate parallel import product), can undercut the marketing strategy and profitability of a film. In respect, for example, to DVD, the industry has attempted to segment the world market by technical means (i.e. by coding disks for 6 different zones such that disks coded for one zone will not play on DVD players sold in another zone). However, these technical measures are routinely defeated. Protection against parallel imports is required to enforce movie industry marketing strategies. Second, parallel import works are often used to disguise pirated works, and are used as “masters” from which pirated products are made. Allowing parallel imports facilitates pirate activities.

11. Dean Marks (Time Warner) - Mr. Marks emphasized the differentiated character of the copyright industry. He pointed out that, in some countries (e.g., France), national legislation regulates the sequence and timing by which films may be released in the theatrical and home markets. He discussed European Court of Justice decisions which recognize that the sale of a video or laser disk does not exhaust the rental right. He reiterated the view that the distribution right regarding physical works should be consistent with the performance right, and that sale of a physical work should not exhaust the copyright in respect to re-distribution. He observed that contracts are not effective in regulating foreign distributors, even at the intra-corporate level. Time Warner foreign affiliates sell to wholesalers who are not subject to privity of contract with the parent company, and these wholesalers resell works. He turned to the question of digital distribution of copyright works. He noted that the sale of books by Amazon.com over the Internet is distinct from the sale of digital texts themselves. Use of the Internet as a selling tool does not seem to raise particularly unique questions. Regarding direct digital delivery, he believes that such distribution should be treated as a broadcast or public performance, and that it is the intent of the new WIPO treaties that the “making available” right should be treated as subject to the control of the copyright holder (i.e. that electronic delivery is not subject to exhaustion).⁷²

Mr. Marks said that in his view the copyright is a territorial right, and that policy-makers tended to overlook this legal reality in considering parallel imports issues. It appears to be accepted that performance and related rights are territorial, but in his view the distribution right is also territorial. International conventions accept that copyright is governed by national law. The right of the copyright holder can be invoked whenever a work enters a national territory. Mr. Marks suggested that competition law would not be an effective instrument for addressing parallel import restrictions because intellectual property laws grant protection for the exercise of

⁷²Mr. Marks indicated that the treaties do not expressly provide this, but queried whether an interpretation agreed to at the initiative of the United States would have this effect.

market power unless there is an abuse of power.

12. Beatrice von Silva-Tarouca (Warner Music Group) - Mrs. Silva-Tarouca sought to counter the idea that parallel imports may lead to lower prices for consumers and higher royalties for artists in the recording industry. She said that parallel traders restricted their activities to successful international recordings for which resale was assured, and retained parallel import profit margins without passing price differentials on at the retail level. She indicated that recording companies would not lower their prices in response to parallel imports because they are restricted from doing so by contracts with artists and because parallel import price differentials have a short duration. She observed that if parallel imports caused recording company profits to drop, that the impact would be felt by local niche artists rather than international artists because recording companies would cease to subsidize the niche market. She said that CD prices were 30% lower in the United States than in Europe because artists in America receive lower royalties, and because America is an homogenous market where marketing costs are lower. She indicated that recording companies have adapted to parallel imports in Europe because the market there is now largely homogenous. She said that recording companies charge concessionary prices in emerging markets such as Russia, and in weak copyright countries such as Saudi Arabia, and that if parallel imports from these markets were permitted then the recording companies would respond by raising prices in these markets. She said that pirate CDs are very difficult to distinguish from legitimately produced CDs and that allowing parallel imports places a burden on customs officials, thereby encouraging piracy. She indicated that allowing parallel imports from the United States and Canada would result in small European recording companies being taken over by large American recording companies with the net result that niche music would be less likely to be marketed in Europe and elsewhere.

In response to questions from Hartmut Johannes, Mrs. Silva-Tarouca noted that low cost CDs sold in countries such as Saudi Arabia are often supplied at very low prices from the same European production facilities which supply the European market, that such products are delivered free of copyright and royalty fees, and that reduced copyright and royalty fees are paid by the distributor upon subsequent sale of the product at a low price. However, Saudi distributors may, for example, re-export the product at a high price back to the European market, while having paid the low copyright and royalty fee. She also indicated that licensees of Warner CD products may engage in “overpressing” – that is, exceeding the quantity of production permitted by contract – and then exporting the excess product to high price markets. Warner has difficulty enforcing its contracts *vis à vis* its own licensees.

Mr. Johannes also observed that industry claims that low price CD exports from the United States would threaten local recording companies in countries such as Australia was undercut by the fact that almost all worldwide production of CDs is controlled by five multinational producers. The location of the recording artist and the location of the production facility are distinct matters and it is, in his view, difficult to see how the location of CD production facilities in an integrated global market will determine the source of music (i.e. where the artist will record).

13. Ronnie Williams (Publishers Association of Britain) - Mr. Williams largely addressed issues connected with electronic commerce. He suggested that those who argued that on-line delivery

of books would eliminate the need for territorial restrictions were doing so out of self-interest. Databases regarding the holders of copyright would in fact allow on-line suppliers to limit distribution of materials to territories where licenses were granted, and publishers had offered to make such databases and technology available to on-line providers, so far without success. Territorial protection for copyright holders and restrictions on parallel importation are important to book sellers because they allow investments to be made that are tailored to local markets, and this provides encouragement for artists. He also indicated that publishers were willing to grant concessionary royalty arrangements to developing country printers, but only the condition that their product did not enter and compete in the the developing country markets. Parallel imports could tip this scale against developing countries, and result in less availability of knowledge and information. He indicated that publishers do not want to be restricted in their choice of options between territorially restricted distribution or global distribution, but wanted to retain both options. In all events, the right to impose vertical restraints by contract must be recognized, and existing contract rights should be respected even when parallel import regimes change. He also expressed concern that parallel importation encourages piracy, and believes that the New Zealand book market will be affected by increased piracy.

14. Chris Creswell (Government of Australia)⁷³ - The government of Australia has adopted legislation in regard to parallel importation of copyrighted works that differs in regard to the type of work. In respect of books, the legislation permits parallel importation only if a book published abroad is not made available in Australia within 30 days after foreign publication. As of July 30, 1999, there will be no restrictions on the parallel importation of sound recordings. As of February 2000, there will be no restrictions on parallel importation of copyrighted packaging and labeling. This legislation was favorably influenced by the U.S. Supreme Court decision in *Quality King v. L'anza*. The government has been presented with conflicting reports on whether to permit parallel imports of computer software, and has not acted on this subject matter. There is no action underway in respect to films. In regard to New Zealand, legislation adopted in 1998 removed all restrictions on parallel importation of copyrighted materials. One of the main concerns of the New Zealand government was to prevent automobile manufacturers from raising prices in the New Zealand market based on protection of copyrighted designs. Industrial design protection in New Zealand is principally a matter of copyright law, and since New Zealand does not produce automobiles locally, there was concern that producers and distributors would attempt to enforce higher than world market prices through enforcement of copyright laws. Mr. Creswell suggested that one effect of Australia legislation requiring 30 day availability of books was to increase local production of books in Australia. He said that the various legislation was too recently implemented to allow for conclusions regarding overall effects on pricing. Although Australia had been identified on a USTR Special 301 list because of contemplated changes to its parallel imports legislation, Mr. Creswell was not apprized of any representations that might have been made by USTR subsequent to adoption of its sound recording legislation.

15. Marco Bronckers (ITLC)⁷⁴ - Marco Bronckers summarized his detailed paper regarding the

⁷³See paper provided subsequent to meeting, *supra* note 16.

⁷⁴See Marco C.E.J. Bronckers, *The Exhaustion of Patent Rights under World Trade Organization Law*, 32 J. WORLD TR. L. [] (1998), attached as Annex 14.

legal implications of the TRIPS Agreement on the issue of exhaustion and parallel importation. He made two principal points. First, he considers that Article 6 of the TRIPS Agreement permits each WTO Member to follow its own approach to the regulation of exhaustion/parallel imports, and that this precluded individual members from imposing trade sanctions against other members based on their choice of parallel imports regime. Second, he rejects an interpretation of the WTO agreements which would permit exhaustion/parallel imports issues to be evaluated under agreements other than the TRIPS Agreement (*e.g.*, GATT or GATS) since, in his view, the TRIPS Agreement represents a specific agreement among members to deal with this issue in a certain way. Marco Bronckers also indicated his belief that the result of the Uruguay Round was to place the protection of IPRs on an equal status with the principles of liberal trade, and that governments decided against reconciling the conflict between the two competing sets of rules in TRIPS Article 6. Despite the fact that the WTO Agreement preamble does not refer to IPRs protection, the TRIPS Agreement is one of the three pillars of the WTO system, and IPRs protection is not subject to an overarching WTO preference for free trade.

16. Thomas Cottier (ITLC)⁷⁵ - Thomas Cottier also summarized his detailed paper on this subject matter. He finds it of interest that the governments in the TRIPS negotiations did not consider in depth the principal interface of trade and IPRs protection, *i.e.* the exhaustion issue. The Appellate Body must ultimately decide whether GATT or GATS rules are relevant to the exhaustion issue, or whether Marco Bronckers' view is correct and that only the TRIPS Agreement can be taken into account. In any case, from a policy standpoint Thomas Cottier believes that the subject of exhaustion and parallel importation is better taken up under the GATT and GATS since the main issues relate to the circumstances under which the free movement of goods and services may be restricted. Under the GATT, for example, evaluation may proceed by applying the Article XI prohibition against quotas in light of the Article XX(d) exception for measures necessary to protect IPRs. He believes that the idea of territoriality underlying customary IPRs protection is an outmoded concept in view of the integration of the world economy, and that Article XX(d) can be used to address situations where government policies lead to economic distortions. The second main point of Thomas Cottier's presentation was that regional exhaustion does not appear permitted by TRIPS national treatment and MFN rules, and he questions the legal basis for the EU's rule of intra-Union exhaustion as limited by the *Silhouette* decision. He suggests that the ECJ's decision to preclude member states from following a rule of international exhaustion may constitute the imposition of more restrictive regional measures in the sense precluded by GATT Article XXIV. He finally suggests that additional attention should be paid to the interface between the GATS and the exhaustion issue.

Adrian Otten commented from the floor that he remains to be convinced that the GATT and GATS cannot be used to address the exhaustion issue. He also asks whether the starting point for GATT analysis should not be Article III (national treatment) rather than Article XI (quotas). He recalls that, in the US Section 337 case, the Panel considered that US patent protection measures were to be examined under Article III even though the measures at issue constituted prohibitions of imports applied at the border. He also noted that in theory an Article

⁷⁵Thomas Cottier, *The WTO System and the Exhaustion of Rights*, draft of November 6, 1999, for *Conference on Exhaustion of Intellectual Property Rights and Parallel Importation in World Trade*, Geneva, Nov. 6-7, 1998, Committee on International Trade Law, attached as Annex 15.

III analysis of the exhaustion issue could cut two ways. On the one hand, a Member which applied a rule of national exhaustion might be viewed as according imported products no less favorable treatment than products of domestic origin since in both cases the first sale in the territory of that Member would exhaust rights. In this regard, it had to be recalled that Article III concerned the respective "internal" treatment of imported and domestically produced goods. On the other hand, a Member applying an international exhaustion regime could also be viewed as treating domestic and imported products in the same way since in both cases first sale anywhere in the world would exhaust rights. Thomas Cottier indicated that since parallel importation generally involves the movement of goods across borders, that he has considered application of Article XI to be more appropriate, but that this issue might be given further attention.

Another commentator from the floor indicated that the EU intra-Union exhaustion doctrine is covered under the grandfather clause of TRIPS Agreement Article 4(d). It was also suggested that since the EU is a Member of the WTO it is unnecessary to apply Article XXIV to it.

17. Sydney Templeman (U.K. House of Lords, retired) - Lord Templeman observed that in English law restrictions on the alienation of moveable property are not permitted except when a direct contractual relationship is involved. The Statute of Monopolies introduced a limited system by which patent holders could restrain competition, but that goods placed on the market with the consent of the patent (and copyright) holder were not subject to restraint under English law. Therefore, there is no question of exhaustion, strictly speaking, in English law. Trade marks have always been understood to identify the origin of goods and were never intended to provide a right to control marketing. There is no basis in English law for the holder of a trade mark to restrict parallel imports. He is highly critical of the ECJ's *Silhouette* decision which introduces unwarranted discrimination between products introduced onto different markets. He does not suggest that there should be no restrictions on parallel imports since there might be cases where restraints can be justified, but he finds it doubtful that increasing pharmaceutical company profits is ample justification. Lord Templeman cannot fathom why a consumer in the UK should pay 30% more for a CD than his or her American counterpart. His main concern, however, is with the impact of parallel import restriction on developing countries whose industries are denied access to developed country markets. He does not believe that industrialized country exporters will withdraw from developing country markets if faced with the prospect of parallel imports. He does not believe that empirical evidence will provide solutions to these policy questions, and he would advocate following the approach adopted by Australia – to gradually eliminate restrictions on parallel imports and see what happens.

18. Hartmut Johannes (formerly of DG IV, presently of counsel to Akin, Gump, Strauss, Hauer & Feld, Brussels)⁷⁶ - Mr. Johannes reviewed the history of EU law on the subject of parallel importation. He recalled the court decisions from various member state courts that had supported international exhaustion in the field of trademarks, and the shift that was initiated by the German Supreme Court decision in the *Dyed Jeans* case, followed by the ECJ's decision in *Silhouette*. He faults the ECJ for failing to define the function of the trademark in *Silhouette*, since it is clear that there would be no consumer deception. He rejects Advocate General Jacobs' suggestion that

⁷⁶See fax memorandum furnished to European Commission, *supra* note 22.

allowing different member state rules would result in the creation of inter-member barriers since, inter alia, the ECJ had already countenanced such barriers in the *Ideal Standard* case. He notes that the Court's reciprocity argument was ill-conceived since most of the EU's major trading partners allow parallel imports in trademarked goods. He does not believe that trademarks provide a holder with the right to control distribution of goods. He wondered whether the court would have allowed Silhouette to impose a contractual restriction on the resale of its products into the Union under Article 85 EC Treaty in light of its prior case law. If not, why should the Court countenance the use of trademark rights to accomplish the same ends?

19. Hugh Hansen (Fordham Law School) - Hugh Hansen argued that individual attitudes concerning parallel imports policies were conditioned by an array of cultural, social and political factors. He found it rather doubtful that the present proceedings would result in any change in the perceptions of the participants because of these various factors. In his view, those who favor international exhaustion are generally hostile to intellectual property rights protection and to integrated vertical control by producers. This is because strong producer controls tend to produce stark economic outcomes in terms of winners and losers, and those who favor international exhaustion tend to favor social protection over sharp competition. He does not agree that the function of trademarks is limited to identifying the origin of goods. He believes that investments in advertisement, distribution services and so forth are entitled to protection as property of the investor, and that one is no more entitled to appropriate someone else's investment in goodwill than to hijack a truckload of goods. Why, he asks, should we accept an artificial distinction between tangible and intangible property? Producers should be entitled to restrict the parallel importation of trademarked goods because this increases the efficiency of their vertical distribution chain, increases inter-brand competition, and promotes productivity gains. Protecting the losers in economic competition is properly the role of social welfare policy, and not IP law.

20. William Cornish (ITLC) - Bill Cornish suggested that contrary to the opinion of some members of the ITLC, he considered that IPRs laws remained the most appropriate framework within which to evaluate parallel importation issues since the IPRs law had historically been used for this purpose. He agreed that the exhaustion issue encompassed policy issues extending beyond the domain of IP in a strict sense, but did not believe that this made IPRs an inappropriate venue within which to consider these issues. He stressed the overall complexity of the subject matter, and that ultimately the various questions involved balancing various interests, and that reasonable people could disagree as to how interests should be stressed. He suggested that legislators and courts would find it difficult to draw narrow distinctions among different types of IPRs and to define different approaches to different product sectors, though the Australia legislature appeared to be following this path. He disagreed with Lord Templeman on discriminatory pricing in respect to developing countries since he suspects that there may be greater advantage to maintaining availability of low price products. Bill Cornish believes that each of patent, copyright and trademark should be evaluated separately, and made the following distinctions. Patents are a policy choice to encourage innovation and rapid publication. In light of the beneficial effects of the patent grant from a socio-economic perspective, he considers that producers should be permitted to maximize returns by segmenting markets via parallel imports restrictions. The copyright presents a weaker case. The copyright is more restrictive in scope than patent right, but the copyright term in consequence is longer. Copyright is intended to provide an economic incentive. He does not find the case for national exhaustion of copyright

compelling, but he thinks that the best course may be to leave copyright exhaustion policies to each government's discretion. Regarding trademarks, he agrees that they should be limited to identifying the origin of goods, and that he does not see a socio-economic justification for generally banning parallel imports of trademarked goods. However, he stressed that there should likely be exceptions for cases in which there are material differences among trademarked goods such that consumer confusion or injury might result. On the whole he would recommend that the ITLC keep this subject under continuous study, but not "offer world leadership."

Jeremy Carver (ITLC) responded to Bill Cornish's remarks by observing that other members of the Committee had sought to analyze and make proposals regarding the exhaustion/parallel imports question in light of the increasing interdependence of the world economy and the declining adequacy of territoriality as an organizing principle. He agreed with Lord Templeman that rights should not be restricted on a national basis. He said that, as lawyers, members of the ITLC should endeavor to find and propose solutions.

Ernst-Ulrich Petersmann (ITLC) suggested that quantitative restrictions reduce consumer welfare, that trade policy instruments are not optimal policy instruments for correcting market distortions that do not arise at borders, and that the territorially-based IPRs are not suited to changes in the world market. He noted that if national courts and legislators had difficulty analyzing and coming to decision about parallel import policies, then this in fact argued in favor of a recommendation by the ITLC. The ITLC should specifically propose that quantitative restrictions in the form of IPRs protection should be subject to justification.

Mayer Gabay also responded to Bill Cornish's remarks to disfavor merely holding the exhaustion question open for further study. He recommended that the Committee state clearly that international exhaustion should be the rule for trademarks, and that parallel imports should not be allowed in the field of patents. The most difficult area is that of copyright, as to which the Committee should indicate various factors and views regarding different areas. There should be no clear cut position of the Committee in the copyright field.

Bill Cornish, in reply to the remarks of Jeremy Carver and Ulrich Petersmann, emphasized that his position was grounded in the *realpolitik* of national legislative processes, and that he did not believe there was a basis for consensus on worldwide rules. Therefore, we are forced back to the national legal processes presently at work. The Internet, he observed, may instigate a movement toward uniform prices for various copyrighted products. However, this has yet to occur. He suggested that rules restricting parallel imports may be fairly efficient policy instruments for providing incentives in the patent and copyright fields. In response to a comment from the floor, he indicated that competition law may be one approach to accommodating the trade and IPRs legal regimes.

Frederick Abbott responded to this exchange by suggesting that it may be possible to identify a quasi-consensus of views among Committee members on certain points. He does not agree with Mayer Gabay that there is basis for a uniform view in the area of patents, since there is evident division among Committee members in this area. This stems at least in part from the well-known difficulties in weighting and balancing the value of patents for economic welfare. These difficulties spill over into balancing the relative value of open trade and patent protection,

and result in differences in views among Committee members.

21. Otto Licks (Momsen, Leonardos & Cia., Brazi) - Mr. Licks indicated that Brazil has adopted legislation barring parallel imports in the fields of patent, copyright and trademark and that the courts have recognized only very limited exceptions to this legislation.⁷⁷ He said that the TRIPS Agreement has been directly applied by the Brazilian courts, and that Article 27 and 28 (patents) have been held to bar parallel importation. He observed that traders in Brazil absorb price differentials in parallel trade and do not pass savings on to consumers, and that in several sectors parallel import goods are priced 10-20% above locally-originating goods. Mr. Licks had earlier commented on a case in which the distributor/licensee of a trademark in Brazil had been allowed to block the importation of a used helicopter from the United States bearing the equivalent trademark.

22. Hans Peter Kunz-Hallstein (Attorney, Munich)⁷⁸ - Dr. Kunz-Hallstein advocated maintaining national autonomy on the exhaustion/parallel importation issue, consistent with the view expressed by Bill Cornish. He observed that the Paris Convention does not establish a rule of territoriality, but only the independence of patents. Countries which do not provide a right of importation do not violate the Paris Convention. Moreover, he does not think that the TRIPS Agreement establishes an exclusive right of importation. Dr. Kunz-Hallstein supported the decision of the German Supreme Court in the *Dyed Jeans* case and the judgment of the ECJ in the *Silhouette* case on the grounds that the courts properly interpreted the First Trade Marks Directive. The EU legislature changed EU trademark law, adding that the trademark is a business asset. In *Silhouette*, the ECJ deviated from its earlier jurisprudence regarding the function of the trademark in response to the legislature. The AIPPI once attempted to reach consensus on the exhaustion issue and failed, and it has since been unwilling to take up the issue. He recalled that the developing countries had pressed for reform of the Paris Convention, and that in the end the U.S. blocked this effort under pressure from industry groups. This ultimately led to the TRIPS Agreement, which was quite contrary to what the developing countries had intended. In the same way, pressing for an international exhaustion rule even in the field of trademarks may have unintended consequences since producer groups would view this as a threat. When there are worldwide patents and trademarks it may be time to revisit this question and consider rules of international exhaustion.

23. Mr. Meinhard Novak (Legal Secretary, EFTA Court) - Mr. Novak reviewed the reasoning of the EFTA Court in the *Mag Instrument* case. He does not think that there is a conflict between the EFTA decision and the ECJ decision in *Silhouette*. He disagreed with an observation by Mr. Kunz-Hallstein that the ECJ had altered its view of the function of trademarks in *Silhouette*. In Mr. Novak's view, the ECJ did not say anything about the function of trademarks in that case, but rather confined itself to trade issues.

⁷⁷The one case used to illustrate an exception involved a direct import-export transaction between two affiliates of the same firm, which would not generally (from a U.S. standpoint) be considered a parallel trade transaction.

⁷⁸See Hans Peter Kunz Hallstein, [AIPPI paper], attached as Annex 16.

B. Rapporteur's Observations regarding November 1998 Meeting

The November 1998 meeting was very useful to Committee members, to this Rapporteur, and to outside participants. It provided the opportunity for the presentation and exchange of views, and for contributions regarding factors affecting specific industry sectors. The various presentations from industry representatives served to illustrate the arguments which those industries have heretofore made largely in abstract terms. On the whole, the industry illustrations were consistent with the analytical framework presented in the First Report.

1. Copyright

The copyright industry representatives illustrated the argument that, in their view, prohibitions on parallel importation afford them the opportunity to discriminate on the basis of price across markets and to protect their local investments in goodwill (advertisement), as well as to market their products in an orderly fashion (e.g., sequential distribution of films). Each of these interests was identified and taken into account in the preparation of the First Report.

The copyright industry representatives indicated a special interest in the welfare of developing countries, particularly whether the industry would preserve the capacity to provide inexpensive reading materials in these countries without the prospect of parallel exports to the developed countries. There remain certain empirical questions regarding the copyright industry's interests. Are reading materials in fact available at very low prices in developing countries through the good offices of the copyright industries? Are such low priced materials of sufficient quality that their export to developed markets would undermine the position of the copyright holders in those markets? If the developing countries could in fact produce high quality reading materials at low cost, what is the reason why production should not be transferred to those countries?

Putting aside for the moment these empirical questions, just as some special accommodations might be made in the pharmaceuticals sector for the supply of very low price pharmaceuticals to developing countries, so might the TRIPS Agreement and GATT 1994 accommodate the special interests of the copyright industry in supplying very low cost educational materials to the developing countries without compromising a general preference for the free movement of goods and services. The Berne Convention already includes special provisions for developing country exploitation of copyrighted materials, and these provisions are incorporated by reference in the TRIPS Agreement.⁷⁹

2. Patents and Pharmaceuticals

The representative of the pharmaceutical industries also highlighted their particular interests in the segregation of markets by restrictions on parallel importation. Their main argument is that price controls distort international and regional markets, and they are unfairly prejudiced by being subject to free movement of price-controlled drugs. As these representatives acknowledged, the First Report is sympathetic to the fact that price controls create trade

⁷⁹See Article 9:1, TRIPS Agreement, and reference to Appendix to Berne Convention.

distortions, and that it specifically addresses the way in which such distortions may be taken into account. As was noted in the Discussion Paper, the special interests of the pharmaceutical industries in supplying very low cost drugs to developing countries might be accommodated by existing rules in the TRIPS Agreement and GATT 1994 which encourage certain exceptional treatment for developing countries. At a June 1999 UNCTAD seminar at which this issue was discussed, certain developing country representatives expressed surprise that the pharmaceutical industries might be supplying their countries with very low cost drugs. In recent months, some integrated pharmaceutical manufacturers have indicated an intention to provide low-cost AIDS drugs in Africa, though the extent of this commitment remains somewhat obscure. In only the past few days, the U.S. Export-Import Bank announced a program to lend money to African countries so that they may purchase drugs to combat the AIDS pandemic. It will be of some interest to observe the price at which drugs are sold by the pharmaceutical producers under this publicly-subsidized program.

3. Trademarks

Regarding trademarks, a private attorney from Brazil indicated that local distributors of foreign produced products prefer rules prohibiting parallel imports because these rules prevent low-priced imports from undermining local investments in goodwill (e.g. servicing). From the standpoint of this Rapporteur, the illustrations suggested that as overt trade barriers, such as tariffs and quotas, are reduced in developing country markets, trademarks might be invoked as a new generation of barriers to inhibit price competition and the development of globally competitive industries. Other speakers suggested that maximization of vertical distribution control by producers is inherently pro-competitive and beneficial. This Rapporteur remains unconvinced that producers are unable to protect their distribution interests by contract, and that fixed rules enforcing world market segregation are necessary or useful.

4. Competition Law Approach

Several participants at the meeting raised the question whether parallel importation issues might be dealt with by competition laws, especially in the sense of abuse of dominant position. There is no question but that competition laws are a useful mechanism for addressing abuses of IPRs, including abusive prohibitions on parallel importation. Nevertheless, the volume of world trade in IPRs protected goods and services, and the relative paucity of actions brought by competition authorities and private parties, makes it most unlikely that enforcement by competition authorities would be an effective mechanism for addressing the question of parallel importation. The transaction costs of each individual proceeding are too substantial.

5. The Role of Traders

One the most interesting repeated comments from industry representatives at the November meeting, also reflected in the NERA Report, is that “traders keep the profits from parallel trade, so that consumers do not benefit.” The suggestion is that traders take unfair advantage of producers, without providing any corresponding benefit to consumers.

It might be noted that “traders” are a vital element of the international trading system.

They have been responsible for the discovery and opening up of markets since the dawn of human history. The trader serves to distribute goods and services to their most highly valued use, and to assure that price competition is maintained in global markets. Parallel trade would generally not occur unless traders spotted and took advantage of price differentials among markets. Purchasers of parallel traded goods and services – whether at the wholesale or retail level – must certainly (save in exceptional cases) be obtaining some advantage; whether in terms of price or availability. By forcing producers to price their goods competitively across markets, parallel traders increase the efficiency of the world trading system, and create systemic benefits for consumers.

The critique of traders implies that their activities should be restricted. Can this perspective really be consistent with the principles underlying the WTO?

V. Digital Electronic Commerce, GATS and Exhaustion

A. Digital Electronic Commerce

As noted in the First Report, the exhaustion of rights issue was considered in connection with the negotiations on the WIPO Copyright Treaty and WIPO Performances and Phonograms Treaty.⁸⁰ In each case, governments adopted a formula which is substantively equivalent to the TRIPS Agreement Article 6 agreement not to agree, leaving to each treaty party the right to adopt its own exhaustion policy.⁸¹ Some of the interpretative difficulties surrounding the WCT

⁸⁰See First Report, at 609-610.

⁸¹Representatives of the copyright industries at the November 1998 Geneva conference suggested that the Agreed Statements to the WIPO Copyright Treaty (WCT) and WIPO Performances and Phonograms Treaty (WPPT) might somehow control the exhaustion of rights in digital works in a manner that would have implications for the question of the international exhaustion of rights. That such Agreed Statements do not have this effect is manifest from the text of the treaties and the Agreed Statements. As noted in the First Report, the WCT and WPPT each expressly provide that “Nothing in this Treaty shall affect the freedom of the Contracting Parties to determine the conditions, if any, under which the exhaustion of the right [of distribution] applies after the first sale or other transfer of ownership of the original or a copy ...” (WCT, art. 6(2), WPPT, art. 8(2) & art. 12(2)).

A WCT Agreed Statement (WCT/AS) provides that “storage of a protected work in digital form in an electronic medium constitutes a reproduction within the meaning of Article 9 of the Berne Convention (WCT/AS, concerning art. 1(4)). This Statement does not explicitly address the distinction between ephemeral and permanent storage despite proposals that were made to explicitly address ephemeral storage. (See Pamela Samuelson, *The U.S. Digital Agenda at WIPO*, 37 VA. J. INT’L L. 369 (1997), regarding uncertainty surrounding the meaning of this provision based upon its express text and negotiating history). As noted in the text above (*see* Case 2b), acceptance of the premise that ephemeral reproduction constitutes copying in the sense of the Berne Convention would in any case lead to further interpretative questions regarding the WCT. A WPPT Agreed Statement (WPPT/AS) also provides that electronic storage constitutes reproduction (WPPT/AS, concerning arts. 7, 11 & 16), raising the same interpretative issues as the comparable WCT/AS.

A WCT/AS provides that “As used in these Articles [6 & 7], the expression “copies” and “original copies,” being subject to the right of distribution and right of rental under the said Articles, refer

and WPPT no doubt arise from the contentious and hectic atmosphere in which the negotiations were concluded (*see* Samuelson, *id.*, for a detailed chronology of the WCT negotiations). In any case, there is no basis to conclude that these Agreements have conclusively answered the issue of the international exhaustion of rights in digital works, particularly in light of the express reservation of this issue in response to Chairman's alternative proposals on the subject (*see* First Report, *supra*).

Digital electronic commerce has dramatically increased in importance since the Committee initiated its work program regarding exhaustion of rights and parallel importation.⁸² In May 1998, the WTO Ministerial Conference adopted a Declaration on Global Electronic Commerce which called for the establishment of a work program in this field, and indicated that WTO Members would continue their practice of not imposing tariffs on electronic transmissions.⁸³ Among other issues being considered at the WTO is whether GATS or GATT 1994 rules are more appropriate to the regulation of the digital environment.⁸⁴

Digital electronic commerce involves a variety of elements, including *inter alia*:

1. The use of digital networks as a means to promote sales and conclude transactions in respect to physical products and services;
2. Transactions involving digital works such as music, videos, databases and software, and;
3. The use of identifiers of products and services (*e.g.*, trademarks and service marks) and identifiers of digital network locations (*i.e.*, domain names) on the Internet and other digital networks.

Case 1

With regard to the use of digital networks as advertising and sales media for physical

exclusively to fixed copies that can be put into circulation as tangible objects" (WCT/AS, concerning arts. 6 & 7). This Statement purports to clarify the basic distribution and rental rights, yet does so in a way that appears to limit the subject matter over which right holders may exercise control (by excluding coverage of the distribution and rental of purely digital works). A WPPT/AS likewise contains a comparable reference to "copies" as "tangible objects", again appearing to place limitations on the scope of control of right holders (WPPT AS, concerning arts. 2(e), 8, 9 12 & 13)). Although other provisions of the WCT and WPPT address the making available of digital works, they do not clarify the issue of exhaustion (*see, e.g.*, WCT art. 8, concerning right of communication to the public).

⁸²For an in-depth discussion and analysis of the emergence of digital networks and their potential impact, *see* WIPO, *The Management of Internet Names and Addresses: Intellectual Property Issues, Report of the WIPO Internet Domain Name Process*, <http://wipo2.wipo.int>, April 30, 1999.

⁸³<http://www.wto.org>, adopted May 20, 1998.

⁸⁴Rapporteur's discussion with WTO Secretariat personnel.

products and services (para. 1 above), there do not appear to be any special issues raised in respect to the exhaustion of IPRs (*i.e.*, that are not otherwise raised with respect to the movement of IPRs protected goods and services). The question whether an IPR such as a trademark, copyright or patent will be exhausted (from an international standpoint) when a physical good or service is placed on the market with the consent of the right holder -- over a digital network -- will continue to generally be determined by the law of the country of importation, unless an international rule on exhaustion is agreed upon.⁸⁵

Case 2

With regard to the distribution of digital works over electronic networks (and most particularly, the Internet) (para. 2 above), issues regarding the exhaustion of IPRs are rather significant. It may be that precisely the same analysis with respect to IPRs protected goods and services should be applied in the digital environment as in the “physical world”. Nonetheless, the speed and intensity with which transactions on the Internet are taking place argues that particular attention be paid to this emerging issue area.

As a starting point for analysis, it may be suggested that delivery of a product or service to an end-user over the Internet constitutes a sale or transfer of that product or service to the end-user, just as such sale or transfer would take place in physical space. The end-user/transferee of a musical recording, video or software product would be entitled to transfer that product to another party, just as that end-user/transferee would be entitled to transfer a physical product (e.g., a book). The copyright industries have expressed at least two layers of concern with regard to digital transactions.

Case 2a

The first concerns the ease by which end-user/transferees may copy digital works and re-transfer them, and may do so without eliminating the “master” from which they have made a copy. It is considerably easier to duplicate and re-transmit the digital text of a book than to photocopy and transfer a physical book.

The technical ease with which copies may be made in the digital environment is an issue which governments must address at the national and regional level, as well as at the international level. The answer to the question whether the holder of a copyright should retain control over a digital work subsequent to its delivery to an end-user over a network has both a national and an international dimension. If the copyright is exhausted at the national level (*i.e.*, so that a re-transfer may take place nationally), should that exhaustion also permit the end-user/transferee to re-transmit the work to another party in another country? Just as with respect to the exhaustion question in respect to physical goods and services, one might ask why a distinction should be drawn between the national and international spheres.

Perhaps the principal difference between the physical world and digital world is that the

⁸⁵Note that Judge Laddie’s opinion in the *Davidoff* case, *supra* note 12, suggests certain reliance on the law of the country where the first sale takes place.

digital world virtually eliminates transportation and related transaction costs, and so sharply reduces the barriers to international trade in digital works. Furthermore, in the digital world, there are – at least at the moment – few governmental restrictions on the movement of works across borders, and the ability of copyright holders to distinguish among markets on the basis of territorial borders is limited. Unless governments step in to regulate the movement of digital works at national and regional borders, international exhaustion of copyright and other IPRs may become -- or remain -- a fact of the digital environment.

Case 2b

The second area of concern of the copyright industries relates to “ephemeral” or transient copies. Before a digital work transmitted over the Internet is displayed on a video screen, it is processed by the computer and stored temporarily in the computer system. If the visual image is not downloaded into fixed storage (e.g. onto hard disk media), it is no longer resident in the computer system after its display has been terminated.

The question arises from a copyright standpoint whether the transient storage of the data embodying a visual image is a “reproduction” of the work.⁸⁶ If such storage is reproduction, then the mere act of viewing information made available over the Internet might -- in theory -- constitute copyright infringement. Of course, if a copyright holder makes visually perceptible data available over the Internet, a license to reproduce for the purpose of viewing the image may be implied. Yet if the copyright holder has implicitly consented to reproduction for the purpose of viewing, has it exhausted its control over subsequent reproduction of the image – such as by downloading or printing? If the copyright holder’s control is exhausted, is it exhausted nationally, or internationally?

Because of difficulties that arise from the transient reproduction of digital works, the copyright industries may prefer to characterize such reproduction as “broadcast” or “performance”, and thereby exercise greater control over the downstream reproduction of such material. Yet even the characterization as broadcast or reproduction has its own difficulties, since existing copyright and neighboring rights conventions distinguish between rights to control “public” and “private” viewing of works. These difficulties were alluded to by speakers from the copyright industries at the November 1998 conference.

The characterization of transient digital copying, and the rules applied to such copying, have implications for the movement between end-users of such works, and ultimately of the movement between nations and regions of such works. As noted earlier, the issue of exhaustion of rights was specifically reserved to each country which becomes party to the WIPO Copyright Treaty and/or WIPO Performances and Phonograms Treaty.

To a certain extent, questions regarding the international exhaustion of copyright in transiently reproduced digital data may be better answered when international standards regarding such data become more clear. Nevertheless, it is well to be aware that there is an

⁸⁶See note 81, *supra*, regarding interpretative uncertainties surrounding the WCT and WPPT and their Agreed Statements.

important international exhaustion dimension to this phenomenon, and that general concepts applicable in the physical domain may also be relevant to this part of the digital domain.

Case 3

With regard to the use of trademarks, service marks, domain names and other identifiers in the digital environment, it may be that such use will highlight the extent to which the concept of territoriality is no longer useful in respect to the interconnected world economy.⁸⁷ The principal argument of the trademark industry in respect to the territorial segregation of markets (i.e. for national exhaustion) is that it allows investments in goodwill related to products to be captured at the national and regional level. The argument is that local distributors will lack the incentive to advertise, and to provide service and support for products, if parallel imports of trademarked goods are permitted. To a great extent, the Internet assumes the existence of a global market in which goods and services can be ordered from anywhere, and delivered to anywhere. In this environment, it may be less likely that trademark holders will be able to justify restricting the movement of goods and services on the grounds that local investments in goodwill would be undermined.

B. GATS

The First Report specifically addressed films and other broadcast materials from the standpoint of exhaustion rules. It recommended that the approach followed by the European Court of Justice in its *Coditel I* decision be followed in this area.⁸⁸ That is, that the first showing of a film or other work which depends for its earnings on repeated showings not be considered to exhaust the rights of the copyright holder. To the extent that films and broadcasts are considered to constitute services, this specific aspect of the services trade was addressed in the First Report. In other respects, the First Report did not seek to differentiate between goods and services from the standpoint of international exhaustion analysis. It may be useful to briefly visit whether such a distinction is useful or necessary.

Intellectual property is inherently intangible. Its capacity for free movement is well known. An IPR may attach to a service as well as a good. “Service mark”, for example, is a specific designation for a trademark which attaches to a service. Internet “domain names” serve to identify the location of sites on a digital network,⁸⁹ and these sites have inherent characteristics of services. Audio-visual works are often considered to be services, and are protected by copyright and neighboring rights. The U.S. Court of Appeals for the Federal Circuit has allowed the patenting of a method of calculation, provided that such method is useful.⁹⁰ As

⁸⁷This fact was alluded to both by William Cornish and Thomas Cottier at the November 1998 meeting.

⁸⁸See First Report, at 625-26, 636.

⁸⁹See WIPO Report of Internet Domain Name Process, *supra* note 82.

⁹⁰See *State Street Bank & Trust Co. v. Signature Financial Group*, (Fed. Cir.) 1998 U.S. App. Lexis 16869 (decided July 23, 1998).

Thomas Cottier has pointed out, a patented production process or method might well be considered a service.⁹¹ A trade secret may inhere in a method of doing business which is commercially valuable and which its holder has kept confidential.

The General Agreement on Trade in Services (GATS) has addressed areas such as professional services (e.g., accounting, architectural, legal, medical, etc.), financial services (e.g., banking, brokerage, insurance), telecommunications (basic and value added), tourism and transportation, and so forth. The extent to which IPRs may adhere to different forms of services involves a number of complex technical issues. Each of the services sectors and subsectors just enumerated will present its own analytical issues. For example, accounting firms may employ unique methods of quantitative analysis to client operations, and may present reports to clients based on the use of such analytical methods. Certain of those methods may constitute trade secrets (under specified conditions), and might (or might not) be patentable under evolving patent doctrines. An accounting firm generally would not exhaust its trade secret right in an analytical method by the act of presenting a report to its client based on the accounting firm's own use of the analytical method. However, the report presented to the client – for the client's use – may not be subject to IPRs protection (again, depending on various factors).⁹² The client may be free to transmit copies of the resulting report to third parties, and may be free to transmit the report across national borders.

The relationship between IPRs and the services industries is inherently complex. Nevertheless, there may not be a special justification for allowing IPRs holders to prevent the movement across national and regional borders of IPRs protected services that have been legitimately sold and transferred to third parties.

VI. Suggested Consensus Proposal of Committee

This Rapporteur remains of the view that rules restricting parallel importation of trademarked, copyrighted and patented goods and services are not generally beneficial to world economic welfare. As a personal view, the Rapporteur would recommend that WTO Members adopt a general rule of international exhaustion of IPRs for the multilateral trading system as proposed in the First Report. As noted in the First Report, certain exceptions to a general rule would be envisaged. Based on additional analysis and factors as presented in this preliminary Second Report, certain additional exceptions to accommodate special interests of developing countries might also be considered, such as an exception to accommodate very low cost educational materials placed on markets in developing countries with the consent of developed country copyright holders. In addition, in the field of trademarks, it might be noted that parallel import goods and services which are materially different, and might cause consumer confusion or injury, should be identified as such (i.e. labeled) so as to avoid confusion or injury.

Some Committee members favor continuation of present multilateral policy, which is that

⁹¹See Cottier, *supra* note 75.

⁹²As with respect to legal services, there may well be issues in connection with various protective client privileges involved, but these are distinct from IPRs issues.

each WTO Member may make its own determination as to appropriate exhaustion/parallel importation policies and rules.⁹³ In this regard, it may be useful to recall certain reasons underlying the proposal for a uniform multilateral rule, as well as to consider an important consequence of the present situation.

Shortly after the conclusion of the Uruguay Round, it became evident that at least one important WTO Member country did not regard the agreement not to agree contained in TRIPS Agreement Article 6 as a satisfactory resolution of the exhaustion/parallel importation issue. There was and remains some prospect that WTO Members will be encouraged to adopt particular exhaustion/parallel importation policies and rules, and this encouragement might be coupled with the implicit or explicit threat of trade sanctions (or related economic consequence). One motivation for the proposal of an agreed multilateral rule was to reduce the risk of disputes among WTO Members.

There is, moreover, an important reason beyond drafting elegance or symmetry for proposing a uniform multilateral approach to the exhaustion/parallel importation question. The adoption in a single WTO Member of exhaustion/parallel importation policies and rules has consequences for other WTO Members. So, for example, the adoption of a rule restricting parallel importation of trademarked goods in an industrialized Member will necessarily have effects on the export opportunities of developing Members. The decision by the European Union to mandate an exclusive intra-Union trademark exhaustion rule opens up the EU market to parallel trade, but it forecloses parallel import opportunities from Brazil, India, Thailand and the United States. This may represent a substantial trade preference in favor of goods produced within the EU.

Because a discretionary decision by each WTO Member on the exhaustion/parallel importation issue affects other WTO Members, a decision by the Committee to recommend national and regional discretion to formulate and adopt exhaustion/parallel importation policies and rules would not be a “neutral” recommendation. It is a recommendation that carries with it important trade policy implications. From the standpoint of this Rapporteur a recommendation in favor of national/regional discretion is preferable to a recommendation exclusively in favor of national or regional exhaustion policies and rules.

Some portion of Committee members generally share the views of the Rapporteur in favor of recommending a generally applicable multilateral approach. Other members favor recommending a continuation of national and regional discretion. For purposes of deciding upon a Committee recommendation, one alternative for the Committee was to poll each member as to his or her view, and then make a recommendation, if any, pursuant to the views of the majority. The views of the minority might then have been incorporated as an alternative view in the Committee’s report to the ILA.

However, it is more in keeping with the practice of the WTO to seek a consensus view. The following proposal reflects the compromise reached among members of the Committee at its

⁹³Some Committee members have suggested that a recommendation in favor of maintaining national and regional discretion would reflect current world trade *realpolitik*.

June 25, 1999 meeting at WIPO. It reflects the culmination, at least for the time being, of the Committee's active work program on this subject matter.

**Proposal of the Committee on International Trade Law for an
ILA Resolution Regarding the Exhaustion of Intellectual Property Rights and
Parallel Trade**

Draft of February 16, 2000

The Committee on International Trade Law of the International Law Association, having studied the subject of the exhaustion of intellectual property rights and parallel trade, and having carefully considered the views and recommendations of interested persons and groups, including governments, businesses, consumers, economists and lawyers:

1. Recalls that WTO Members are obligated by the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement) to take effective measures to prevent trade in goods and services that are produced and distributed in a manner that infringes rights in intellectual property, including trade marks, copyrights and patents.

2. Recalls that WTO Members are obligated by the General Agreement on Tariffs and Trade 1994 to respect the principle of national treatment (non-discrimination), and that each WTO Member is obligated to treat imported goods on an equivalent basis with goods produced within its territory.

3. Recalls that Article 6 of the TRIPS Agreement provides that "For the purposes of dispute settlement under this Agreement, subject to the provisions of Articles 3 and 4 [national and most favored nation treatment, respectively] nothing in this Agreement shall be used to address the issue of the exhaustion of intellectual property rights."

4. Notes that an intellectual property right is subject to exhaustion [in many countries] when a particular good to which it pertains has been placed on a market with the consent of the right holder. Upon the exhaustion of an intellectual property right, the holder of that right may no longer control the distribution or movement of that good. Parallel importation and exportation involves trade in specific goods that have been placed on markets with the consent of intellectual property rights holders. Under a doctrine of national (or regional) exhaustion, the placing of a good on a national (or regional) market exhausts the right of the intellectual property holder only in respect to that national (or regional) market. Under a doctrine of international exhaustion, the placing of a good on any national (or regional) market exhausts the right of an intellectual property holder in respect to all markets.

5. *Notes* that goods placed on the market with the consent of intellectual property rights holders must be distinguished from counterfeit and pirated goods, and that distribution of counterfeit and pirated goods (*i.e.* goods produced without the consent of rights holders) is never subject to exhaustion of rights, but is instead prohibited by the TRIPS Agreement.
6. *Encourages* WTO Members to refrain from threatening or taking actions with respect to Member government policies which permit parallel trade into their territories in so far as such policies are consistent with the terms of the TRIPS Agreement.
7. *Notes* that the principal function of the trade mark is to identify the source of goods in commerce for the benefit of consumers. Trade marks also serve to protect the goodwill of producers. In order to perform these functions, the law must ensure that goods are marked with the consent of trade mark holders and that consumers are not confused regarding the origin or characteristics of goods. A doctrine of international exhaustion with respect to trade marks is consistent with the objectives of trade liberalization and the promotion of competition, provided that the interests of consumers are safeguarded.
8. *Recommends* that WTO Members recognize a doctrine of international exhaustion with respect to trade marked goods that have been placed on the market by, or with the consent of, the trade mark holder; provided, however, that WTO Members should safeguard the interests of the public and of producers by allowing protection against consumer confusion as to the source and material characteristics of goods.
9. *Notes* that copyright promotes the public interest by encouraging the creation and dissemination of authors' and artists' creative expression and acknowledges that the interests of the public may be served by the free movement between national and regional markets of copyrighted works that have been placed on the market with the consent of the copyright holder. There are, however, circumstances in which the interests of authors and artists in achieving adequate remuneration may justify restrictions on the movement of copyrighted works between markets.
10. *Recommends* that WTO Members continue to inquire into the approach to parallel trade in copyrighted works that is best suited to promoting the interests of the public, recognizing that copyrighted works may be expressed in different forms, including tangible works (such as printed books) and intangible works (such as digitally-stored music); and further recognizing that different approaches might be considered regarding different forms of copyrighted expression.
11. *Notes* that patents serve the public interest by encouraging inventive

activity, investment in inventive activity and the dissemination of information concerning inventions. Patent protection seeks to strike a balance between the interests of inventors and producers in securing adequate rewards by the grant of market exclusivity, the interests of consumers in the benefits of new technologies, and the interests of consumers in the benefits of competitive market prices.

12. *Notes* that certain forms of government regulation in respect to patented products may result in distortions in international trade, and that such regulation might be taken into account in formulating recommendations regarding parallel trade in patented products. Particular product sectors may be regulated differently, and an approach to parallel trade in patented products might involve sectoral distinctions.

13. *Recommends* that WTO Members continue to inquire into the approach to parallel trade in patented inventions that is best suited to protecting the interests of consumers and producers, recognizing that Members may adopt their own national and regional approaches to parallel trade in patented inventions consistently with the terms of the TRIPS Agreement.

14. *Notes* that intellectual property rights are also used in connection with trade in services, and that the subject of the exhaustion of intellectual property rights and parallel trade in services demands further attention.

15. *Encourages* WTO Members to give special attention to the interests of developing countries in parallel trade. Restrictive parallel trade policies have the potential to limit the export opportunities of developing Members, and might impede the development of globally competitive industries. On the other hand, in certain instances, unless restrictive policies are permitted goods may not be made available in the developing country in the first place. Developed Members should take into account the market access interests of developing Members in formulating their parallel trade policies.