

LEGISLATING DIGITAL EXHAUSTION

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ABSTRACT

The digital shift in distribution, from markets premised on disposing of physical artifacts to markets defined by data flows, is among the most important changes in the copyright landscape since the enactment of the 1976 Copyright Act. The disconnect between this new reality and our current statutory rules is particularly evident when it comes to the question of exhaustion. The first sale doctrine embodied within Section 109 was constructed around a mode of dispossession that is rapidly becoming obsolete. As a result, the benefits and functions it has long served in the copyright system are at risk. Building on our earlier work, this Article will argue that a meaningful exhaustion doctrine should survive the digital transition. After explaining the two primary hurdles to digital exhaustion under the existing statutory regime, we outline two possible approaches to legislating digital exhaustion, concluding that a flexible standards-based approach that vests considerable authority with the courts is the better solution.

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I. INTRODUCTION

Register of Copyrights Maria Pallante’s Next Great Copyright Act contemplates a number of shifts in copyright policy in response to the influence of digital technology on markets for protected works.¹ One centrally important, yet largely unexplored, question is the place of a first sale doctrine in copyright law’s digital future.² In her remarks, Register Pallante rightly notes that the first sale doctrine—the rule that copyright holders cede their power to control various uses of a copy of a work after sale or transfer to a consumer—has been part of copyright law for more than a century and has been embraced by both the courts and Congress.³ Yet when it comes to applying this rule to digital copies, she defers to the Copyright Office’s 2001 Digital Millennium Copyright Act Section 104 Report, which recommended against digital first sale out of fears that transfers of works between consumers could “interfere[] with the copyright owners’ control” over the right of reproduction.⁴

Nonetheless, the Register envisioned two scenarios for Congressional action. First, Congress could disavow the doctrine entirely, both because the practice of selling content had been displaced by “licensing” and because of the ease of digital duplication might somehow lead to use of exhaustion to enable mass infringement. This seems to be the opinion of Representative

1. See Maria A. Pallante, *The Next Great Copyright Act*, 36 COLUM. J.L. & ARTS 315 (2013).

2. *Id.* at 331–32.

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

4. U.S. COPYRIGHT OFFICE, A REPORT OF THE REGISTER OF COPYRIGHTS PURSUANT TO § 104 OF THE DIGITAL MILLENNIUM COPYRIGHT ACT, at xix (2001).

Jerry Nadler, the ranking member on the House Subcommittee on Courts, Intellectual Property, and the Internet, who told the Association of American Publishers that the notion that consumers own the digital media that they buy from Apple, Amazon, or other retailers is “an extreme digital view.”⁵ Alternatively, Register Pallante imagines Congress endorsing digital exhaustion as a rejection of a future copyright marketplace in which “everything is licensed and nothing is owned,” but only as long as copies could be “adequately policed” through measures “that would prevent or destroy duplicative copies.”⁶

As our previous work makes clear, we support the extension of copyright exhaustion and its associated consumer property interests to the digital marketplace.⁷ Building on the work of earlier scholars, we have outlined the many benefits exhaustion provides consumers, creators, the public at large, and the copyright system itself. Although we do not intend to detail all of that work here, we will offer a few highlights to underscore what is at stake in this debate. By enabling secondary markets, exhaustion increases access to works by both lowering prices and increasing availability.⁸ It aids in the preservation of old, abandoned, and censored works.⁹ It protects consumer privacy in the acquisition, enjoyment, and transfer of works.¹⁰ Particularly for digital works, exhaustion supports consumer-driven innovation as well as competition between content platforms.¹¹ Exhaustion can also be a powerful tool in justifying a range of noncommercial personal uses of copyrighted material by consumers.¹²

More recently we identified three core functions exhaustion plays in a healthy copyright system.¹³ First, exhaustion preserves authorial incentives.

5. Jeremy Greenfield, *Congressman Nadler: Copyright Law Won't Change This Year, Maybe Next*, DIGITAL BOOK WIRE (Mar. 19, 2014), <http://www.digitalbookworld.com/2014/congressman-nadler-copyright-law-wont-change-this-year-maybe-next/>.

6. Pallante, *supra* note 1, at 332.

7. Aaron Perzanowski & Jason Schultz, *Digital Exhaustion*, 58 UCLA L. REV. 889 (2011); Aaron Perzanowski & Jason Schultz, *Copyright Exhaustion and the Personal Use Dilemma*, 96 MINN. L. REV. 2067 (2012); Aaron Perzanowski & Jason Schultz, *Reconciling Intellectual & Personal Property*, 90 NOTRE DAME L. REV. (forthcoming 2014).

8. *Digital Exhaustion*, *supra* note 7, at 894; Joseph P. Liu, *Owning Digital Copies: Copyright Law and the Incidents of Copy Ownership*, 42 WM. & MARY L. REV. 1245, 1303, 1310–11, 1320–21, 1330–33, 1336 (2001) (privacy, access, preservation, transactional clarity); R. Anthony Reese, *The First Sale Doctrine in the Era of Digital Networks*, 44 B.C. L. REV. 577, 584 (2003) (access, preservation, privacy); Molly Shaffer Van Houweling, *The New Servitudes*, 96 GEO. L.J. 885, 898–905, 914–16 (2008) (transactional clarity and salience).

9. *Digital Exhaustion*, *supra* note 7, at 894; Liu, *supra* note 8; Reese, *supra* note 8.

10. *Digital Exhaustion*, *supra* note 7, at 894; Liu, *supra* note 8; Reese, *supra* note 8.

11. Liu, *supra* note 8; Van Houweling, *supra* note 8.

12. *Copyright Exhaustion and the Personal Use Dilemma*, *supra* note 7.

13. *Reconciling Intellectual & Personal Property*, *supra* note 7.

Because exhaustion applies when rightsholders dispose of lawfully made copies at prices they set, exhaustion encourages fair compensation in return for purchased copies.¹⁴ Second, exhaustion preserves consumer incentives to participate in the legitimate copyright marketplace. Copyright asks consumers to pay supra-competitive prices for protected works, despite their widespread availability at near-zero marginal cost via unauthorized online sources of distribution. How do we convince consumers to make that choice? By making sure consumers have meaningful property rights in their purchases, exhaustion encourages them to participate in authorized transactions. If infringement liability and statutory damages are the sticks, exhaustion is one of the carrots. A book or a movie that carries with it the right of alienation is a more attractive value proposition than one that does not.¹⁵ The ability to store, collect, curate, donate, or bequest one's media also provides incentives to invest in legitimate acquisition. In the non-digital world, we collect books, movies, paintings, and music that we can keep, pass on to friends, resell, or donate. If consumers cannot legally satisfy those expectations in a digital world, they may be more likely to opt out of the legal market and download content without paying for it. Third, exhaustion helps keep transaction costs low. Exhaustion is copyright's version of the *numerus clausus* principle; it limits the forms transactions can take and prevents the proliferation of idiosyncratic bundles of rights.¹⁶ When rightsholders attempt to negate exhaustion with lengthy license agreements, consumer information costs increase dramatically. Such costs are highly inefficient for transactions often marketed as "purchases" and billed at ninety-nine cents each.

Without exhaustion, copyright law would lack any direct means to safeguard most of these benefits and functions.¹⁷ But legislating digital exhaustion cannot and should not simply be an attempt to extend section

14. See also John A. Rothchild, *Exhausting Extraterritoriality*, 51 SANTA CLARA L. REV. 1187 (2011) (discussing the "single-reward theory" underlying exhaustion).

15. For example, when Microsoft unveiled the Xbox One, it announced technology that would restrict the use of pre-owned games, potentially destroying a thriving secondary market and rendering games far less valuable to consumers. The outcry was immediate and deafening. After Sony made clear that its competing console would continue to support used games, Microsoft reversed course. See Don Matrick, *Your Feedback Matters—Update on Xbox One*, XBOX WIRE (June 19, 2013), <http://news.xbox.com/2013/06/update/>.

16. See Christina Mulligan, *A Numerus Clausus Principle for Intellectual Property*, 80 TENN. L. REV. 235 (2012).

17. Those who are critical of exhaustion in the digital age argue that this is something akin to a natural evolution and that exhaustion not only has outlived its usefulness, it now undermines incentives for copyright owners to maximize the flexibility and availability of digital distribution technologies. See Jane C. Ginsburg, *From Having Copies to Experiencing Works: the Development of an Access Right in U.S. Copyright Law*, 50 J. COPYRIGHT SOC'Y U.S.A. 113 (2003).

109 from analog copies to digital ones. Our existing exhaustion rules were crafted with the particular characteristics of tangible copies and analog marketplaces in mind. As explained below, they are framed around deeply embedded assumptions that are on the verge of obsolescence. Building on our earlier work, this Article will argue that a meaningful exhaustion doctrine must be mindful of both the underlying functions the doctrine serves and the quickly shifting technological and market conditions under which it necessarily operates. After explaining the primary hurdles to digital exhaustion under the existing statutory regime, we outline two possible approaches to legislating digital exhaustion, concluding that a flexible standards-based approach that vests considerable authority with the courts is the better solution.

II. THE EROSION OF EXHAUSTION

Much of the debate over a digital first sale doctrine arises from two developments in the copyright marketplace that necessitate a reconceptualization of copyright exhaustion.¹⁸ The first is the shift in the once central role of particular identifiable copies in the distribution of protected works. Although copies have existed since the origins of copyright law, we are shifting quickly into a post-copy world, one where digital works exist as data flows and rarely reside in a material object for more than a transitory period of time, where copies blink into and out of existence on a nearly constant basis.¹⁹ In such a world, expecting consumers, rightsholders, or regulators to keep tabs on individual copies is as useful as demanding that fish track the movements of particular drops of water. Temporary copies are the sea in which we all now swim. The second development is the adoption of licensing terms that purport to preclude ownership of digital goods. Although some courts in software cases have endorsed this effort, the gap between licensing terms and the economic realities of the consumer purchasing experience is widening. Notwithstanding licensing language, consumers intuitively understand the difference between owning, buying, and

18. See *Reconciling Intellectual & Personal Property*, *supra* note 7.

19. See *id.*; see also 17 U.S.C. § 101 (2012) (“‘Copies’ are material objects, other than phonorecords, in which a work is fixed by any method now known or later developed, and from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The term ‘copies’ includes the material object, other than a phonorecord, in which the work is first fixed.”). Some courts have found that if a work only exists for a transitory period, it is not a “copy” under the Act. See Aaron Perzanowski, *Fixing RAM Copies*, 104 NW. U. L. REV. 1067 (2010).

selling content on the one hand, and renting it on the other,²⁰ and have grown accustomed to personal property interests in their media purchases. In fact, the very origin of exhaustion lies in the law's discomfort with restraints and servitudes on personal property.²¹ These concerns are at odds with the idea that a consumer is a mere licensee without any property interest simply because a lengthy license agreement or unread terms of service document says so. These two developments amplify and exacerbate shortcomings in the current statutory exhaustion regime—one drafted with traditional analog distribution chains in mind.

A. THE PARTICULAR-COPY CONUNDRUM

Under current sections 109 and 117, exhaustion only applies to the owner of a “copy.” The copy has been an essential concept in copyright law for centuries.²² However, changes in storage and distribution technologies, alongside shifting media consumption patterns, have profoundly altered the way we interact with copyrighted works. The tangible copy, once the primary means of distribution, has been displaced by cloud storage, streaming, and software-as-a-service. Copies were once finite, stable, and valuable. But today's marketplace is characterized by ubiquitous, temporary instantiations of works that have diminished independent value. Copyright law has struggled to assimilate these developments.

Perhaps the most profound change has been the shift from the distribution of physical products to the exchange of networked information. We used to buy books printed on pages, movies stored on plastic discs, and

20. See, e.g., Vikram Savkar, *The Connected Casebook Coming Soon from Wolters Kluwer Legal Education*, ASPEN LAW, <http://www.aspenlaw.com/connected/> (last visited May 18, 2014); Joel Johnson, *You Don't Own Your Kindle Books, Amazon Reminds Customer*, NBC NEWS (Oct. 24, 2012, 7:43 AM), <http://www.nbcnews.com/tech/gadgets/you-dont-own-your-kindle-books-amazon-reminds-customer-f1C6626211/>; Mattrick, *supra* note 15; Letter from Mary Koelbel Engel, Assoc. Dir., Federal Trade Commission, to M. Sean Royall, Gibson, Dunn & Crutcher LLP (June 23, 2010), available at http://www.ftc.gov/sites/default/files/documents/closing_letters/wal-mart-stores-inc./100623walmartletter.pdf.

21. *Kirtsaeng v. John Wiley & Sons*, 133 S. Ct. 1351, 1363 (2013) (“The ‘first sale’ doctrine is a common-law doctrine with an impeccable historic pedigree. In the early 17th century Lord Coke explained the common law’s refusal to permit restraints on the alienation of chattels.”).

22. 1 Stat. § 124 (1790) (titled “An Act for the encouragement of learning, by securing the copies of maps, Charts, And books, to the authors and proprietors of such copies, during the times therein mentioned”); see also Miaoran Li, *The Pirate Party and the Pirate Bay: How the Pirate Bay Influences Sweden and International Copyright Relations*, 21 PACE INT’L L. REV. 281, 307 n.11 (2009) (discussing the quotation “To every cow belongs her calf, therefore to every book belongs its copy” from A.D. 541); Crown Revenues Act of 1553, 7 Edw. VI, c. 1, § 17 (Eng.), reprinted in 4 STATUTES OF THE REALM 161 (1819) (equating “copy” with “duplicate” in a statute regarding the regulation of treasury accounts).

music encoded in vinyl records. Today we obtain our media as a stream of bits accessed through the cloud. In almost every sector, including books, music, software, and games, digital sales are surpassing traditional physical transactions. Dramatic improvements in remote computational capacity and storage, along with increasingly fast and pervasive data connectivity, allow consumers to acquire, store, and access their media through the cloud. Consumers can choose between cloud storage services from Amazon, Apple, Dropbox, Google, and Microsoft, among others, at nearly no cost. But the cloud has moved beyond mere storage. Amazon's MP3 Store enables consumers to buy, save, and play their purchases directly from its Cloud Player without ever downloading a permanent file to their laptop or mobile device, let alone handling a plastic disc.²³ Software-as-a-service offerings, like Adobe Creative Cloud—the new home for Photoshop and other editing and layout programs—or the Google Apps suite of office productivity tools, prove that remotely accessed data and processing power can provide the functionality that once required the distribution of copies.²⁴ There are lots of reasons to celebrate this transition—e.g., convenience, efficiency, and environmental impact. But there are also reasons to be cautious as copyright law's balance between consumer and creator rights has been structured, in part, around the particular tangible copy.

These technological developments have been accompanied and partly driven by changing consumer preferences. As evidenced by the fact that close to half of Internet traffic is attributable to Netflix and YouTube, many consumers would rather access a library of streaming video titles than purchase or even rent tangible copies.²⁵ The popularity of Spotify, Pandora, and other streaming music services suggest the same might be true for music.²⁶ This transition from distribution to performance is evident in the videogame market as well. OnLive launched a cloud-based gaming platform in 2010.²⁷ And Sony has recently announced Playstation Now, a cross-

23. See *Get Started with the Amazon MP3 Store & Cloud Player*, AMAZON, <http://www.amazon.com/b?node=2658409011> (last visited May 19, 2014).

24. See *Features: Tools and Services*, ADOBE, <http://www.adobe.com/products/creativecloud/tools-and-services.html> (last visited May 19, 2014); *Apps for Business*, GOOGLE, <http://www.google.com/enterprise/apps/business> (last visited May 19, 2014).

25. See Joan E. Solsman, *Netflix, YouTube Gobble Up Half of Internet Traffic*, CNET (Nov. 11, 2013), http://news.cnet.com/8301-1023_3-57611722-93/netflix-youtube-gobble-up-half-of-internet-traffic/.

26. Lauren DeLisa Coleman, *Why Apple's iTunes Radio Isn't a Threat to Pandora or Spotify . . . Yet*, THE DAILY BEAST (Nov. 12, 2013), <http://www.thedailybeast.com/articles/2013/11/12/why-apple-s-itunes-radio-isn-t-a-threat-to-pandora-or-spotify-yet.html>.

27. See *About OnLive*, ONLIVE, <http://www.onlive.com/about/> (last visited May 19, 2014).

platform service that will allow subscribers to rent and stream games to consoles and mobile devices.²⁸ Taken together, these changes threaten to destabilize our understanding of the copy and its place in the copyright system.

B. OWNERSHIP AND THE LICENSING DEBACLE

The question of copy ownership has been central since the inception of copyright exhaustion.²⁹ However, it did not emerge as a main point of contention until the software era.³⁰ For a number of reasons—early uncertainty surrounding the availability of federal intellectual property protection, the prevalence of software embedded in leased hardware, and the recognition by early software companies of the advantages of restricting resale—software transactions typically included licensing terms that rendered ownership somewhat ambiguous.³¹ Courts responded to these licensing efforts with a range of inconsistent approaches for determining whether consumers own the software they acquire.³² Although some courts have embraced licensing as a means for rightsholders to escape the consequences of exhaustion, the effects of the licensing paradigm have been generally contained to the software industry. But as more traditional copyrighted works move to primarily digital models of distribution, and as more retailers of digital content insert restrictions into their terms of service, this approach could have ripple effects across the entire copyright economy.³³

28. See Brian Solomon, *GameStop Plunges After Sony Unveils PlayStation Now Streaming Service*, FORBES (Jan. 7, 2014), <http://www.forbes.com/sites/briansolomon/2014/01/07/gamestop-plunges-after-sony-unveils-playstation-now-streaming-service/>.

29. See, e.g., *Clemens v. Estes*, 22 F. 899 (C.C.D. Mass. 1885); *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339 (1908).

30. See DOUGLAS E. PHILLIPS, *THE SOFTWARE LICENSE UNVEILED: HOW LEGISLATION BY LICENSE CONTROLS SOFTWARE ACCESS* (2009); Michael J. Madison, *Reconstructing the Software License*, 35 LOY. U. CHI. L.J. 275 (2003); Robert W. Gomulkiewicz & Mary L. Williamson, *A Brief Defense of Mass Market Software License Agreements*, 22 RUTGERS COMPUTER & TECH. L.J. 335 (1996); Mark A. Lemley, *Shrinkwraps in Cyberspace*, 35 JURIMETRICS J. 311 (1995).

31. Those licenses often claimed that the “software” was licensed not sold. But they failed to distinguish between the software as the intangible copyrighted work and the software as the particular copy embodied in material objects.

32. See *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010); *UMG Recordings, Inc. v. Augusto*, 628 F.3d 1175 (9th Cir. 2011) (audio CD); *United States v. Wise*, 550 F.2d 1180, 1192 (9th Cir. 1977) (film prints); *Classic Concepts, Inc. v. Linen Source, Inc.*, Nos. 04-8088, 04-8457, 2006 U.S. Dist. LEXIS 96767, at *49–50 (C.D. Cal. Apr. 26, 2006) (copyrighted design on a rug); *Old W. Realty, Inc. v. Idaho State Tax Comm’n*, 716 P.2d 1318, 1320–21 (Idaho 1986) (books); *Middlebrooks v. Comm’r*, 34 T.C.M. (CCH) 1187, at *12–15 (T.C. 1975) (magazines).

33. See, e.g., Savkar, *supra* note 20.

Many copyright holders and retailers have already attempted to take the courts' imprimatur of software licenses as *carte blanche* to transmute any digital purchase into a non-exhausting transaction. Examples in the copyright marketplace of claims that consumers do not actually own the copies they buy are common.³⁴ Amazon's Kindle Store is among the largest sellers of ebooks in the United States. According to Amazon's Terms of Use, consumers who discover a book they would like to read and hit the "Buy now with 1-click®" button do not own the copy they download.³⁵ As those terms explain, "[u]nless specifically indicated otherwise, you may not sell, rent, lease, [or] distribute . . . any rights to the Kindle Content."³⁶ Apple's iTunes Store, the largest music retailer in the world, reflects a somewhat more conflicted characterization.³⁷ After describing its transactions as "purchases" and noting that "[a]ll sales . . . are final," Apple insists that consumers agree not to "rent, lease, loan, sell, [or] distribute" their purchases.³⁸ Amazon's competing MP3 store offers similar terms. Although Amazon's store "enables you to purchase digitized versions of audio recordings," your payment merely "grant[s] you a non-exclusive, non-transferable right to use the Music Content only for your personal, noncommercial purposes."³⁹ However, "you may not redistribute, . . . sell, . . . rent, share, lend, . . . or otherwise transfer or use the Music Content."⁴⁰

This sort of restraint on alienation is inconsistent with copyright law's understanding of copy ownership and at odds with consumers' reasonable expectations of the word "buy." Rather than clarifying the central concept of ownership, as exhaustion has historically done, the proliferation of licensing

34. See Mulligan, *supra* note 16, at 254 ("The Microsoft Office 2010 license . . . specifies that its software 'is licensed, not sold.' . . . Furthermore, Microsoft software marked 'Not for Resale' cannot be resold.").

35. See, e.g., Product Description Page of TENTH OF DECEMBER: STORIES, AMAZON, <http://www.amazon.com/Tenth-December-Stories-George-Saunders-ebook/dp/B008LMB4C2/> (last visited Feb. 4, 2014).

36. *Kindle Store Terms of Use*, AMAZON (Sept. 6, 2012), <http://www.amazon.com/gp/help/customer/display.html?nodeId=201014950>.

37. See Christine Monaghan, *iTunes Store Sets New Record with 25 Billion Songs Sold*, APPLE (Feb. 6, 2013), <http://www.apple.com/pr/library/2013/02/06iTunes-Store-Sets-New-Record-with-25-Billion-Songs-Sold.html>.

38. *iTunes Store Terms and Conditions*, APPLE (Sept. 18, 2013), <http://www.apple.com/legal/internet-services/itunes/us/terms.html>; see also Evan Hansen, *eBay Mutes iTunes Song Auction*, CNET NEWS (Sept. 5, 2003), <http://news.cnet.com/2100-1027-5071566.html> (noting the removal of an eBay auction of song purchased from iTunes).

39. *Amazon MP3 Store Terms of Use*, AMAZON (Aug. 13, 2013), <https://www.amazon.com/gp/help/customer/display.html?nodeId=200154280>.

40. *Id.*

as a means of describing digital-media transactions has only confused things further. Taken together, the shifting role of the copy and the growing acceptance of licensing suggest that the current legal framework is unlikely to provide the kind of flexibility necessary to extend exhaustion into the digital environment.

C. SHORTCOMINGS OF THE CURRENT ACT

Instability in the concepts of the “copy” and “ownership” in the digital environment are further exacerbated by shortcomings in the current Copyright Act. First, it fails to define the sorts of transactions that trigger ownership and exhaustion. Sections 109 and 117 limit their exhaustion defenses to the “owner” of a copy. Ownership is the characteristic that distinguishes between the public at large and the subset of consumers who are entitled to the benefits of exhaustion. As such, ownership is a powerful limitation that helps alleviate fears of an unprincipled application of exhaustion rules that could enable widespread infringement. But while the Copyright Act defines *copyright* ownership, it lacks any definition of *copy* ownership and remains silent on the broader question of consumer property interests in media. Particularly in light of the concerns we express above over the ways licensing language obscures ownership interests, if Congress revisits exhaustion in the digital context, it should clarify the circumstances under which exhaustion applies. Given the rapidly diminishing role of the tangible copy, thinking strictly in terms of copy ownership is probably unproductive. But whether tied to particular copies or not, exhaustion depends on maintaining some identifiable form of consumer ownership.

Moreover, for a time, some courts and many legal scholars believed that our current copyright preemption doctrines were viable enough to keep clever contractual attempts to undermine ownership, and thus exceptions and limitations such as fair use and exhaustion, at bay.⁴¹ Sadly, preemption no longer offers that promise, primarily because various courts have read section 301 to focus primarily on the question of whether state laws grant *rights* that are equivalent to any of the exclusive section 106 rights, not whether they attempt to negate any of the exceptions and limitations afforded under the Copyright Act.⁴² Explicitly expanding preemption to include exceptions and limitations would ensure that exhaustion could not be so easily undermined by contractual terms.

41. See Mark A. Lemley, *Beyond Preemption: The Law and Policy of Intellectual Property Licensing*, 87 CALIF. L. REV. 1111 (1999); *Vault Corp. v. Quaid Software, Ltd.*, 847 F.2d 255 (5th Cir. 1988).

42. See *Davidson & Assocs. v. Jung*, 422 F.3d 630 (8th Cir. 2005); *Bowers v. Baystate Techs., Inc.*, 320 F.3d 1317, 1325–26 (Fed. Cir. 2003).

Second, the existing statute defines the rights that ownership exhausts too narrowly. At its core, exhaustion reflects a decision that personal property interests trump intellectual property interests in some circumstances.⁴³ In the 1909 and 1976 Acts, the primary interface between those two sets of interests was the right to vend or distribute copies of the work. But the focus of exhaustion need not be confined to distribution. Section 109 also addresses exhaustion of the public-display right, and section 117 permits reproduction and creation of derivative works for computer programs.⁴⁴ Historically, copyright exhaustion evolved at common law in a way that recognized the importance of exhausting the reproduction and derivative work rights to the extent they interfered with the reasonable personal property interests of consumers.⁴⁵ Today, a singular focus on distribution is particularly inappropriate. A digital copy can rarely be transferred or perhaps even accessed without making another copy. In the realm of digital distribution, copies are not distributed from point A to point B; they are created and reproduced across the network and in the cloud on a near-constant basis. Consumers of these services no longer own or interact with any particular copy, but rather a stream of fungible instantiations of a work. A new exhaustion statute must shift its focus from distribution to account for the necessity of copying.

III. LEGISLATING DIGITAL EXHAUSTION

Given the shortcomings of the current statutory language, we see two paths toward legislating digital exhaustion that track the basic distinction between rules and standards.⁴⁶ One is a detailed list of legislatively-crafted exceptions and counter-exceptions that spell out the rights reserved for consumers and those reserved for copyright holders. The second is a more flexible framework designed to give courts both guidance and significant leeway in determining the uses consumers can make of their purchases, while keeping in mind the interests of rightsholders. Below we outline these two approaches and assess their costs and benefits.

43. See *Reconciling Intellectual & Personal Property*, *supra* note 6.

44. See 17 U.S.C. §§ 109, 117 (2012).

45. See *Digital Exhaustion*, *supra* note 6. Patent law has also approached its exhaustion regime similarly. See *Quanta Computer, Inc. v. LG Elecs., Inc.*, 553 U.S. 617, 631–32 (2008) (extending exhaustion from product to method patent claims when they embody essential features of the patented invention).

46. See generally Pierre J. Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985).

A. DIGITAL EXHAUSTION RULES

The current statutory approach to copyright exhaustion is a largely rule-based one. Sections 109 and 117 spell out in considerable detail the rights of consumers to reproduce, alter, display, and alienate their purchases of copyrighted material.⁴⁷ In an effort to anticipate the wide range of uses consumers may make of their purchases, these rules draw fine distinctions between favored and disfavored behaviors on the basis of a number of factors: the type of work, the type of use, the identity of the user, and the legal relationship between the user and the work. The result is an elaborate inventory of permitted and prohibited uses, articulated with remarkable specificity.

For example, section 109 permits owners to display their copies to the public “either directly or by the projection of no more than one image at a time,” but only “to viewers present at the place where the copy is located.”⁴⁸ This provision enables a museum to hang a painting it owns in a gallery or to project an image of it to museum patrons, but prohibits the creation of a live video feed for the whole world to enjoy.

Of course, section 109 also includes the first sale rule, which permits copy owners “to sell or otherwise dispose of” their copies.⁴⁹ But that general grant of consumer rights is subject to a cascade of narrow exceptions and counter-exceptions. Congress determined that some types of works, namely phonorecords and software, were more vulnerable to the threat of rental markets.⁵⁰ So although anyone can sell or give away their music or software collections, section 109 prohibits rental, lease, or lending of such works.⁵¹ But not all software was spared from the rental market. If a program happens to be a videogame or embedded in a “machine or product” it can still be rented, leased, or lent.⁵² Further, Congress thought rental, lease, or lending would prove harmful only when done for “purposes of direct or indirect commercial advantage.”⁵³ Therefore lending of software and phonorecords between friends remains lawful, as does lending by nonprofit libraries, so long as “each copy of a computer program which is lent by such library has affixed to the packaging containing the program a warning of copyright.”⁵⁴

47. See 17 U.S.C. §§ 109, 117 (2012).

48. *Id.* § 109(c).

49. *Id.* § 109(a).

50. *Id.*

51. *Id.* § 109(b)(1)(A).

52. *Id.* § 109(b)(1)(B)(i).

53. *Id.* § 109(b)(1)(A).

54. *Id.* § 109(b)(2)(A).

Section 117 sets up an equally complex regime of carefully tailored consumer rights. Section 117 permits owners of copies of computer programs to make additional reproductions and derivative works for two purposes. First, consumers can create reproductions to the extent they are essential to the use of the program that they purchased.⁵⁵ Second, consumers can create them for archival purposes, subject to a requirement that “all archival copies are destroyed” once the consumer no longer has the right to possess the program.⁵⁶ The statute also extends familiar first sale concepts to copies and adaptations lawfully made by consumers. However, the sale, lease, or transfer of those copies and adaptations is subject to some important restrictions. Exact copies can be transferred so long as the original copy and any other rights in the program are transferred simultaneously.⁵⁷ Adaptations, however, require copyright-holder permission before they can be transferred.

The Next Great Copyright Act might embrace this approach. Congress could identify the most important use cases, determine whether they should fall within the scope of copyright exhaustion, and craft statutory language that reflects the necessary requirements and limitations. For example, Congress could begin with a baseline exhaustion rule that permits consumers who buy digital goods to transfer ownership of those purchases, even if that entails reproducing a file, but to also require the seller to delete all of her copies of, or otherwise disable her access to, the transferred content. Such an approach would track the existing framework in Section 117 for computer programs, which requires consumers to transfer or delete all of their copies of a program when transferring ownership. This general rule would allow consumers to sell unwanted tracks from iTunes, eBooks from Amazon, or videogames from the PlayStation Network, among other digital content. Although we see no strong justification for distinguishing between different types of works when it comes to resale rights, Congress could conceivably permit transfer of some works but not others. Congress might also place restrictions on the parties entitled to engage in resale. It could, for example, permit individual consumers to resell their digital purchases while prohibiting commercial resale operations.

Likewise, Congress could choose to permit, prohibit, or place limits on rental and lending. Much like it did with phonorecords and software, the legislature could identify certain classes of works the markets for which are particularly susceptible to the threat of secondary rental and lending business models. Works characterized by high prices and limited reusability, like

55. *Id.* § 117(a)(1).

56. *Id.* § 117(a)(2).

57. *Id.* § 117(b).

college textbooks and industry reports, might be plausible candidates for such restrictions. However, the steep prices for such works might instead be interpreted as evidence that secondary markets are necessary to reduce barriers to access. Congress should distinguish between prices that reflect high upfront production costs and those driven by aggressive rent-seeking in determining whether rental restrictions are appropriate.

Aside from exempting specified types of works from consumer rental rights, Congress could impose a number of other restrictions. Again, it might distinguish between individual consumers and institutional actors and commercial aggregators. It might permit nonprofit lending but prohibit commercial lending. It might limit the number of times of times a consumer could lend her digital content, or the frequency with which it is lent, in order to introduce some of the transactional friction that characterized analog lending. Perhaps most promisingly, Congress might draw a distinction between private and public lending in much the same way the current Act differentiates between private and public displays and performances.⁵⁸ Under such a regime, a consumer could rely on statutory exhaustion when she lends her ebook to a close friend or relative, but not when she lends it to a stranger.

Beyond delineating the rights consumers would enjoy under an updated exhaustion regime, Congress would be wise to address the failure of the current act to meaningfully define the sorts of transactions that trigger exhaustion in the first place. The current statutory language hinges on copy ownership without bothering to define it. Assuming Congress is committed to a bright-line rule, there are a number to choose from. Exhaustion could be triggered by any transaction that requires no ongoing payments and results in perpetual possession of a copy or access to the work. Or Congress could adopt a rule that conditions exhaustion on the terms of license agreements attached to works. Or it could allow state law to settle the question of ownership.

Although our previous work makes clear that we would favor some outcomes over others, our goal here is not to detail or endorse any particular set of statutory exhaustion rules. Instead our aim is to provide a sketch of the sorts of inquiries Congress would need to undertake, and to underscore the specificity with which it would need to address them. Assuming Congress appropriately balances the rights of consumers, this rule-based approach promises certainty, stability, and predictability. As detailed as they are, the existing rules in sections 109 and 117 are reasonably straightforward. Litigants understand the scope of these exhaustion rules. Although threshold

58. *Id.* §§ 101, 106.

questions like what constitutes a sale or whether a copy was “lawfully made” have proven the more common focus of disputes, the substantive limitations of these rules rarely require litigation.⁵⁹

But certainty and predictability come at a cost. First, prescribing detailed exhaustion rules in the next Copyright Act runs the risk that Congress will strike the wrong balance between consumers and rightsholders. The recent SOPA fight notwithstanding,⁶⁰ consumers have not generally fared well in the copyright legislative process.⁶¹ There is little reason to expect the process of crafting digital exhaustion rules would fully account for the collectively immense but widely dispersed interests of consumers in light of the highly concentrated economic interests of the rightsholder lobby.

Assuming Congress manages an equitable balance of the relevant interests, a rule-based approach faces another difficulty—rigidity in the face of rapidly changing technology. Markets for digital goods have evolved quickly and appear poised to continue to do so. Pairing a dynamically shifting technological and market reality with inflexible rules is likely to quickly lead to statutory obsolescence.⁶² Without frequent legislative intervention, these digital exhaustion rules may ossify and potentially discourage innovation in content delivery markets.

Perhaps even more troublingly, inflexible rules could distort innovation as developers scramble to shoehorn their offerings within the inevitable gaps in the statutory scheme. The Supreme Court’s recent struggle to make sense of *Aereo* is an instructive example of the sorts of unintentional incentives Congress can create through bright-line rules that fail to anticipate technological change.⁶³ *Aereo* offered consumers access to live and recorded broadcast television programming over the Internet. It owned vast numbers of tiny antennae, each dedicated to a single subscriber.⁶⁴ But unlike cable providers, *Aereo* paid broadcasters no licensing fees for the programming it

59. See, e.g., *UMG Recordings, Inc. v. Augusto*, 628 F.3d 1175 (9th Cir. 2011) (holding that delivery of free promotional CDs triggered the first-sale doctrine despite restrictive license); *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010) (holding that license terms avoided the first-sale doctrine); *Kirtsaeng v. John Wiley & Sons, Inc.*, 133 S. Ct. 1351 (2013) (holding that copies manufactured outside of the United States were “lawfully made”).

60. See generally Edward Lee, *THE FIGHT FOR THE FUTURE: HOW PEOPLE DEFEATED HOLLYWOOD AND SAVED THE INTERNET—FOR NOW* (2013).

61. See Jessica Litman, *Revising Copyright Law for the Information Age*, 75 OR. L. REV. 19 (1996) (describing a legislative process dominated by industry insiders).

62. This challenge is not a new one. Copyright law has historically struggled to deal with new technologies legislatively. See Jessica Litman, *Copyright Legislation and Technological Change*, 68 OR. L. REV. 275 (1989).

63. *Am. Broad. Cos., Inc. v. Aereo, Inc.*, 134 S. Ct. 2498 (2014).

64. *WNET, Thirteen v. Aereo, Inc.*, 712 F.3d 676 (2d Cir. 2013).

makes available to consumers.⁶⁵ Aereo's legal argument hinged on the technical design of its system. By providing an individual antenna that transmitted a dedicated content stream to each subscriber, Aereo maintained that it facilitated private performances that, unlike their public counterparts, did not require a license from the copyright holder.⁶⁶ Aereo's system was designed to take advantage of an arguable gap in the web of statutory rules that govern public performances, cable service, and secondary transmissions.⁶⁷ Whether we characterize its engineering choices as diligent efforts to comply with the law or as evidence of a plot to evade it, Aereo's decision to create a massively inefficient content delivery system was no doubt driven in large measure by the detailed—but dated—legal rules it was forced to navigate.

Ultimately, the Supreme Court rejected Aereo's interpretation of the public performance right.⁶⁸ In doing so, the Court showed little interest in the "technological differences" and "behind-the-scenes" details of the design of Aereo's system.⁶⁹ Since they did not change Aereo's "commercial objective" or "significantly alter the viewing experience of Aereo's subscribers," the court avoided a close reading of the statutory language.⁷⁰ In doing so, the Court implicitly rejected a rigid rule-based system that would drive design decisions based on copyright minutiae. Such a scenario serves the interests of the public no better than those of rightsholders.

This is equally true of rigid digital exhaustion rules that would focus on technological details at the expense of broader policy concerns. Given the challenge of adapting a detailed set of exhaustion rules modeled on sections 109 and 117 to the likely shifting sands of digital content markets, we should consider a more flexible option.

B. A DIGITAL EXHAUSTION STANDARD

The second approach to legislating digital exhaustion relies less on the current rules in sections 109 and 117 and more on the flexible framework for fair use embodied section 107.⁷¹ Rather than spelling out in exacting detail a list of consumer dos-and-don'ts, this approach would signal congressional support for the basic notion that consumers have meaningful ownership

65. *Id.*

66. *Id.* at 693.

67. *See* 17 U.S.C. §§ 101, 106, 111 (2012) (defining public performances, secondary transmissions, and cable systems).

68. *Am. Broad. Cos., Inc. v. Aereo, Inc.*, 134 S. Ct. 2498 (2014).

69. *Id.* at 2501.

70. *Id.*; *see also id.* at 2508 (Scalia, J. dissenting).

71. 17 U.S.C. § 107 (2012).

rights in their digital content purchases. It would offer some guiding principles and concrete considerations, but would leave much of the heavy lifting in the capable hands of the courts. This tack trades certainty for flexibility and helps future-proof the next Copyright Act against a rapidly changing marketplace.

Courts have always been central in the creation and application of copyright exhaustion. The common law origins and development of first sale and other exhaustion doctrines are well documented.⁷² The Supreme Court recently emphasized this history in *Kirtsaeng*, describing the first sale rule as “a common law doctrine with an impeccable historic pedigree” dating back to the early seventeenth century.⁷³ As a matter of animating principle, the first sale doctrine “finds its origins in the common law aversion to limiting the alienation of personal property.”⁷⁴ The earliest copyright exhaustion cases were decided in the 1880s.⁷⁵ Those cases distinguished between owners of books, who had a permanent right of possession, and those with limited, conditional possessory interests.⁷⁶ By the turn of the twentieth century, the fundamental notion of copyright exhaustion—that the exclusive rights to vend, copy, and adapt must sometimes yield to the legitimate rights of purchasers—was settled law.⁷⁷ Not surprisingly, when the Court decided *Bobbs-Merrill*, its first opinion on copyright exhaustion, it construed the Copyright Act in accordance with this existing common law.⁷⁸

Thus, when Congress adopted the *Bobbs-Merrill* holding in the 1909 Act, it expressly did “not intend[] to change in any way existing law.”⁷⁹ Nor was the 1976 reformulation of the first sale doctrine intended to disturb the scope or operation of the law as “established by the court decisions and section 27

72. *Digital Exhaustion*, *supra* note 7, at 889 (discussing the history of copyright exhaustion).

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

74. *Sebastian Int'l, Inc. v. Consumer Contacts (PTY) Ltd.*, 847 F.2d 1093, 1096 (3d Cir. 1988); *Digital Exhaustion*, *supra* note 7, at 909–14, 929–31.

75. In the patent context, courts addressed exhaustion decades earlier. *See Bloomer v. McQuewan*, 55 U.S. 539 (1852).

76. *Compare Clemens v. Estes*, 22 F. 899, 900 (C.C.D. Mass. 1885) (refusing to enjoin retail sales, reasoning that “defendants had a right to buy, or contract to buy, books from agents who lawfully obtained them by purchase from the plaintiff or his publishers”), *with Henry Bill Publ'g Co. v. Smythe*, 27 F. 914 (C.C.S.D. Ohio 1886) (enjoining the sale of books where the copyright holder’s agents, to whom no first sale had been made and title had not passed, delivered copies to booksellers rather than subscribers).

77. *Harrison v. Maynard, Merrill & Co.*, 61 F. 689, 691 (2d Cir. 1894); *accord Doan v. Am. Book Co.*, 105 F. 772, 776 (7th Cir. 1901); *Kipling v. G.P. Putnam’s Sons*, 120 F. 631, 634 (2d Cir. 1903).

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

79. H.R. REP. NO. 60-2222, at 19 (1909).

of the present law.”⁸⁰ Instead, the new language merely “restates and confirms” existing law.⁸¹ In short, exhaustion originated and developed as a common law doctrine. Congress acknowledged and sought to preserve the role of the judicial branch, even as they enshrined the rule in the statute.⁸² The fact that courts have always played a central role in shaping copyright exhaustion should give Congress confidence in their ability to decide such cases outside the confines of rigidly prescribed rules.

In much the same way Congress endorsed the common law doctrine of fair use without impeding its future development and its application to new facts,⁸³ Congress could legislate a flexible analytical framework for exhaustion that identifies the central factors courts should consider and trust courts to weigh the competing interests of consumers and creators in a way that serves the goals of the copyright system. Of course, fair use has its share of critics. Some claim it has become too permissive and threatens to become the rule rather than the exception. Others lament that courts focus too narrowly on the statutory factors, neglecting other considerations. Relatedly, some worry that the traditional four-factor analysis has been displaced by a single factor—transformation.

But the most common critique of fair use is that it leads to unpredictable and inconsistent outcomes that offer little by way of useful guidance. Lawrence Lessig has characterized fair use as nothing more than “the right to hire a lawyer.”⁸⁴ But this critique is overstated. Much of the unpredictability of fair use is a function of the dizzying array of factual scenarios this single flexible framework is asked to accommodate. Fair use shoulders everything from parodies, appropriation art, scholarly research, and news reporting, to

80. H.R. REP. NO. 94-1476, at 79 (1976); S. REP. NO. 94-473, at 71 (1975).

81. H.R. REP. NO. 94-1476, at 79 (1976); S. REP. NO. 94-473, at 71 (1975). *See also* *Quality King Distribs., Inc. v. Lanza Research Int'l, Inc.*, 523 U.S. 135, 152 (“There is no reason to assume that Congress intended either § 109(a) or the earlier codifications of the doctrine to limit its broad scope.”).

82. Congress recognized the existing common law of exhaustion in much the same way it recognized fair use. *See* H.R. REP. NO. 94-1476, at 79 (1976); S. REP. NO. 94-473, at 71 (1975) (noting congressional intent intended “to restate the present judicial doctrine of fair use, not to change, narrow, or enlarge it in any way”). Whether the courts have consistently embraced their common-law role in the ongoing development of fair use is a separate question. *See* WILLIAM PATRY, *PATRY ON COPYRIGHT* § 10:8 (2014) (noting that “initially after passage of the 1976 Act, courts lost sight of their common-law role”).

83. The 1976 Act explicitly acknowledged fair use for the first time, enshrining the four factors courts relied upon most often in deciding cases under the common law. H.R. REP. NO. 95-1476, at 65–66 (1976). Congress intended to embody this common-law history without impeding the future development of the fair use doctrine. *Id.*

84. LAWRENCE LESSIG, *FREE CULTURE: HOW BIG MEDIA USES TECHNOLOGY AND THE LAW TO LOCK DOWN CULTURE AND CONTROL CREATIVITY* 187 (2004).

web caching, thumbnails, reverse engineering, and mass digitization. However, if we cluster fair use cases together on the basis of common factual predicates, more predictable patterns emerge.⁸⁵ Moreover, various best practices have emerged that also serve to guide the reasonable application of fair use in different contexts.⁸⁶ In contrast, the range of factual scenarios courts would be asked to address in the exhaustion context is considerably narrower. And by giving courts greater opportunity to analyze cases through the lens of exhaustion, we might ease some of the unreasonable burden that fair use is currently expected to shoulder.⁸⁷

Rather than revealing the faults of a standards-based approach, fair use highlights the primary reasons for favoring exhaustion legislation that utilizes the advantages of common law reasoning. The current fair use framework has proven remarkably resilient and adaptable over the more than a century and a half since it was first articulated in *Folsom v. Marsh*.⁸⁸ Although it has perhaps been overworked at times, the fair use doctrine has managed to cope with an unyielding tide of new works, technologies, uses, and market structures. Fair use remains a workable, if imperfect, tool for courts to probe some of the essential policy concerns of copyright law: balancing the interests of creators against those of follow-on creators and the public at large. By following the fair use model of judicial decision making guided by congressional input, Congress could frame an exhaustion doctrine that explores another central question in copyright law: the relationship between the rights of creators and the rights of consumers who purchase their creations.

The first task for this framework is clarification of the ongoing license-versus-sale debate. When has a consumer made a purchase or otherwise engaged in the sort of transaction that results in the sort of property interest that trigger exhaustion? Again, we have written elsewhere about how we think courts should resolve this question. Here the main focus should be identifying the factors courts should consider, rather than calling for specific outcomes. There are three key factors courts should take into account:

85. See Matthew Sag, *Predicting Fair Use*, 73 OHIO ST. L.J. 47 (2012); Pamela Samuelson, *Unbundling Fair Uses*, 77 FORDHAM L. REV. 2537, 2548–55 (2009); Michael J. Madison, *A Pattern-Oriented Approach to Fair Use*, 45 WM. & MARY L. REV. 1525, 1687 (2004);

86. *Best Practices*, CTR. FOR MEDIA & SOCIAL IMPACT, <http://www.cmsimpact.org/fair-use/best-practices/> (last visited July 29, 2009).

87. *Copyright Exhaustion & the Personal Use Dilemma*, *supra* note 7.

88. *Folsom v. Marsh*, 9 F. Cas. 342 (C.C.D. Mass. 1841).

1. The duration of consumer possession or access;
2. whether the payment structure is one-time or ongoing; and
3. the characterization of the transaction communicated to the consumer, including whether it is referred to as a sale or purchase.

These factors are largely familiar from the license-versus-sale caselaw. For the first factor, consumers who have perpetual or non-term-limited possession of, or access to, a work stand in a different relation to that work than a consumer who rented a copy for a day or a month. The greater the period of possession or access, the more appropriate exhaustion would seem to be. Under the second factor, consumers who receive possession or access in exchange for a one-time fee are more natural candidates for exhaustion than those whose access is conditioned on ongoing payments.

The third factor, however, may require some explanation. Some courts have held that rightsholders can avoid exhaustion by labeling the relevant transaction a “license”⁸⁹ or by asserting restrictions on use or alienation in a license agreement.⁹⁰ Although we agree that the nature of a transaction can be relevant to exhaustion, we do not think the courts’ inquiry should focus primarily on the language chosen by the agreement’s drafter. Like any self-interested party, copyright holders will inevitably attempt to characterize all transactions in their favor. And since so few of us actually read end user license terms—let alone negotiate them—these terms can hardly be read as a “meeting of the minds” between the consumer and the copyright owner. In fact, they often provide little information about how the transaction looks through the consumer’s eyes. In many instances, license agreements structured to avoid exhaustion accompany public-facing marketing that induces consumers to click a shiny button that says “Buy Now” or “Purchase.” Such marketing is often far more relevant to a consumer’s understanding of the transaction than the never-read fine print. Courts should be mindful then, not only of the limited utility of pre-drafted terms, but of the overall impression communicated to consumers about the nature of a transaction.

Though flexible, we think these factors give reasonably clear guidance. If applied consistently, they would offer consumers greater confidence about when they are buying something they can later alienate. Rightsholders could reliably structure transactions to avoid exhaustion by conditioning ongoing access on future payments, or by clearly communicating time-limited access.

89. *See, e.g.,* Microsoft Corp. v. Harmony Computers & Elecs., 846 F. Supp. 208, 213 (E.D.N.Y. 1994).

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

This would allow the continued development of rental, streaming, and subscription business models while simultaneously clarifying the choice between those delivery channels and true sales of digital content for consumers.

Assuming a sale that triggers exhaustion, courts would need to determine whether a consumer's subsequent actions are lawful. As we described above, a workable digital exhaustion doctrine cannot be limited to the distribution right alone. It should also permit limited acts of reproduction, and even the creation of derivative works, to the extent necessary to enable transfers on secondary markets across competing technology platforms. But purchasers of digital content should not be given free reign to copy and distribute their purchases indiscriminately. In assessing whether a consumer's invocation of exhaustion is appropriate, Congress could suggest that courts consider whether:

1. The consumer fully parted with possession of or access to the work;
2. the use deprives rightsholders of a fair return; and
3. the consumer has materially altered the underlying expression of the work at issue.

The first of these factors isolates the central feature of a lawful secondary transaction. Whether permanently or temporarily, resale or lending entails the seller transferring possession or access to the buyer. For digital goods no less than analog ones, such a transaction cannot result in an increase in the number of individuals who can simultaneously enjoy the work. Rather than try to legislate the myriad ways these transfers of possession and access might work in practice through statutory rules, this factor allows courts to focus on the end result—not the mechanics—of a transaction.

The second factor, much like the fourth fair use factor, considers the impact of the use on the incentives of rightsholders. This factor is consistent with the way courts have traditionally approached the question. They often justify exhaustion on the grounds that the rightsholder, having completed a sale, has been fairly compensated.⁹¹ In the analog world, fair compensation

91. See *Platt & Munk Co. v. Republic Graphics, Inc.*, 315 F.2d 847, 854 (2d Cir. 1963) (noting that “the ultimate question embodied in the ‘first sale’ doctrine” is “whether or not there has been such a disposition of the article that it may fairly be said that the patentee [or copyright proprietor] has received his reward for the use of the article”) (quoting *United States v. Masonite Corp.*, 316 U.S. 265, 278 (1942)); *Parfums Givenchy, Inc. v. C & C Beauty Sales, Inc.*, 832 F. Supp. 1378, 1389 (C.D. Cal. 1993) (“[T]he distribution right and the first-sale doctrine rest on the principle that the copyright owner is entitled to realize no more and no less than the full value of each copy or phonorecord upon its disposition.”); *Burke & Van*

was guaranteed by the rightsholder's ability to set the initial price and by the one-to-one nature of secondary transactions. But digital goods differ from their analog counterparts in ways that could not only disrupt existing pricing structures but also undermine incentives for digital distribution and, theoretically at least, investment in new creation. The physical world imposes limits not present in the digital one. Digital goods are more durable and easier to reproduce, at least in the short term.⁹² Perhaps more importantly, the transaction costs of resale and lending are largely eliminated. Under these conditions, courts need the ability to safeguard against unanticipated secondary transactions that could undermine the primary markets for protected works. Distributed lending models, for example, could enable seamless, but non-simultaneous, use of an ebook by thousands of users at little or no cost. This factor would enable courts to interrogate the harmful effect such a platform could have on rightsholder incentives, and could encourage the evolution of balanced resale and rental models over time.

Finally, the third factor prevents exhaustion from becoming a back door to transformative uses better considered under fair use. To be effective in enabling robust secondary markets, copyright exhaustion should permit some limited adaptation by consumers. Just as section 117 allows consumers to adapt their computer programs to work with new hardware and software, courts could endorse format and platform shifting to the degree necessary to alienate or use lawfully acquired content. For example, if an Amazon customer wants to purchase a used Apple iBook, either the buyer or the seller might need to create a new copy in the appropriate format. Assuming such format shifting even constitutes the creation of a derivative work, this factor would help distinguish between technical adaptations and expressive transformations.⁹³ On the other hand, this factor would weigh against permitting fan edits based on the mere purchasing of the underlying raw material. For example, Topher Grace could not defend his eighty-five-minute edit of the three Star Wars prequels on the basis of exhaustion, no matter

Heusen, Inc. v. Arrow Drug, Inc., 233 F. Supp. 881, 884 (E.D. Pa. 1964) (“[T]he ultimate question under the ‘first sale’ doctrine is whether or not there has been such a disposition of the copyrighted article that it may fairly be said that the copyright proprietor has received his reward for its use.”).

92. See Reese, *supra* note 8, at 633–39 (noting the difficulties of preserving readable digital content in an environment in which languages, software, hardware, and file formats undergo rapid change).

93. See 17 U.S.C. § 101 (2012) (defining a “derivative work” as “a work based upon one or more preexisting works . . . in which a work may be recast, transformed, or adapted”).

how many copies of *The Phantom Menace* he bought.⁹⁴ Annotations and commentary would fall somewhere in the middle under this factor. A user who has taken extensive notes on her ebook has arguably created a derivative, but probably has not materially altered the underlying expression.⁹⁵

Ultimately we see these two multi-factor tests, or some variation on them, as the better route to legislating digital exhaustion. They allow Congress to steer the general direction of the copyright exhaustion, but return the doctrine to its judicial origins, where courts can exercise reasonable judgment to craft decisions that bring some measure of predictability and keep pace with the quickening rate of innovation in copyright markets. More importantly, this approach will engage courts in one of the fundamental questions with which copyright law will grapple in the coming decades—the relationship between creators and their customers.

94. See Peter Sciretta, *Topher Grace Edited The 'Star Wars' Prequels Into One 85-Minute Movie and We Saw It*, SLASHFILM, <http://www.slashfilm.com/topher-grace-edited-star-wars-prequels-85minute-movie/> (Mar. 7, 2012).

95. See 17 U.S.C. § 101 (2012) (defining a “derivative work” to include a “work consisting of editorial revisions, annotations, elaborations, or other modifications which, as a whole, represent an original work of authorship”).

