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## Patent Exhaustion: Contractual Limitation and Foreign Sales

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On May 30, 2017, the Supreme Court of the United States decided *Impression Products, Inc. v. Lexmark International, Inc.*,<sup>i</sup> reversing the decision of the Federal Circuit and finding: (1) unanimously that a patentee's sale of a product exhausts all of its patent rights in that item, regardless of any post-sale restrictions the patentee purports to impose either directly or through its licensee; and (2) nearly unanimously (with only Justice Ginsburg dissenting) that an authorized sale of a product outside the United States, just as one within the United States, exhausts all patent rights in that item. Justice Gorsuch took no part in the consideration or decision of the case.

### Background

In broad terms, patent exhaustion (or the “first sale doctrine”) is a judicial doctrine that limits the exclusive rights conferred by a patent grant. The first authorized sale of a patented article by a patentee or its licensee “exhausts” the patentee’s right of exclusion over the article, permitting the purchaser to use, repair and resell the article without liability for patent infringement. The patent exhaustion doctrine does not have its genesis in the U.S. Patent Act, but rather was created and shaped by the courts, and its applicability to various commercial transactions has been a subject of ongoing dispute.<sup>ii</sup> With its decision here, the Supreme Court provides guidance regarding two of the more heavily disputed aspects of the patent exhaustion doctrine; however, several questions remain unanswered.

Lexmark International, Inc. owns a number of patents that cover components of toner cartridges that it designs, manufactures and sells to consumers in the U.S. and abroad. Lexmark offered these cartridges for a discounted price to U.S. consumers who agreed pursuant to signed contracts to use the cartridges only once and not resell them. Certain of these U.S. consumers disregarded this single-use/no-resale contractual restriction by transferring the discounted cartridges to the remanufacturer Impression Products, Inc., who subsequently refilled the cartridges with toner and re-sold them. Impression also acquired cartridges that were sold by Lexmark abroad and imported them into the U.S. to be re-sold.

Lexmark brought suit alleging that Impression infringed Lexmark’s patents by both refurbishing and reselling cartridges subject to the single-use/no-resale restriction as well as importing cartridges first sold abroad into the U.S. Impression did not dispute that existing Federal Circuit precedent precluded its patent exhaustion defense. Rather, it based its claim that it did not infringe Lexmark’s patents on the argument that recent Supreme Court decisions rendered such existing Federal Circuit precedent invalid.

The Federal Circuit rejected Impression’s argument and ruled in favor of Lexmark, holding that: (1) patent exhaustion does not override clearly communicated and otherwise lawful post-sale use or resale

restrictions imposed by a patentee; and (2) authorized sales of patented articles outside of the U.S. do not exhaust U.S. patent rights, even in instances where the authorized seller has not expressly reserved U.S. patent rights.<sup>iii</sup> As discussed in detail below, the Supreme Court reversed the Federal Circuit on both the domestic and international exhaustion holdings and thereby rejected longstanding Federal Circuit precedent on these issues.

## Applicability of Post-Sale Restrictions

Reversing the decision of the Federal Circuit and rejecting Federal Circuit precedent,<sup>iv</sup> the Court held that Lexmark cannot bring a patent infringement suit against Impression to enforce the single-use/no-resale restrictions Lexmark sought to impose on its customers.<sup>v</sup> The Court explained that Lexmark's initial sale of the cartridges caused the cartridges to "pass[] outside of the patent monopoly" and any rights that Lexmark retained stemmed from the contracts with its customers and not the patent law.<sup>vi</sup> The Court further summed up the application of the patent doctrine with respect to post-sale restrictions as follows: "Once a patentee decides to sell—whether on its own or through a licensee—that sale exhausts its patent rights, regardless of any post-sale restrictions the patentee purports to impose, either directly or through a license."<sup>vii</sup>

The Court explained that the Federal Circuit reached a different outcome, in part, due to the Federal Circuit's misunderstanding of the exhaustion doctrine. The Federal Circuit believed the exhaustion doctrine to be "a presumption about the authority that comes along with a sale," whereas it is actually "a limit on 'the scope of the *patentee's rights*.'"<sup>viii</sup> This misunderstanding led the Federal Circuit to the erroneous conclusion that a patentee could prevent an exhaustion of its rights by expressly reserving certain rights when making a sale such that the purchaser would not acquire the withheld authority that is attendant to those rights.<sup>ix</sup> The Court clarified this misconception, writing that the authority to use, sell, or import an item exists independently of the Patent Act. A patent merely affords the patentee the limited right to prevent others from exercising those rights, an exclusionary right that is extinguished by an authorized sale.<sup>x</sup> Therefore, upon the occurrence of an authorized sale, the product sold is freed from the exclusionary right afforded a patentee under the Patent Act and subsequently entitled to the common law presumption against restraints on alienation that applies to non-patented products.<sup>xi</sup>

The Court also addressed the Federal Circuit's concern that preventing patentees from reserving patent rights when they sell goods would create an artificial distinction between those sales and sales by licensees of the patentee. The Federal Circuit understood the Court's decision in *General Talking Pictures Corp. v. Western Electric Co.*<sup>xii</sup> to stand for the proposition that "when a patentee grants a license 'under clearly stated restrictions on post-sale activities' of those who purchase products from the licensee—the patentee can *also* sue for infringement those purchasers who knowingly violate the restrictions."<sup>xiii</sup> Accordingly, the Federal Circuit concluded that if "patentees can employ licenses to impose post-sale restrictions on purchasers that are enforceable through infringement suits, . . . , it would make little sense to prevent patentees from doing so when they sell directly to consumers."<sup>xiv</sup>

The Court rejected the Federal Circuit's conclusion, reasoning that restrictions imposed by a patentee on its licensees do not implicate the same concerns about restraints on alienation as restrictions on a sale.<sup>xv</sup> Specifically, the Court states that patent exhaustion reflects the principle that once an item is sold, it should not be "shaded by a legal cloud on title as it moves through the marketplace."<sup>xvi</sup> A license, on the other hand, does not pass title to a product, but rather is an exchange of rights, and a patentee is free to define the limitations on the grant of such rights to a licensee.<sup>xvii</sup> Accordingly, the Court concludes that

while a patentee may limit the scope of authority granted to a licensee under the patent, including by requiring the licensee to impose restrictions on purchasers, if the licensee complies with the license when selling an item, that sale is considered “authorized” such that exhaustion applies.<sup>xxiii</sup> If the licensee sells products outside the scope of its license, the sale is “not authorized” and exhaustion does not apply. In such a case, the patentee may bring a patent suit against both the licensee and the purchaser.<sup>xxix</sup>

Where a patentee requires its licensee to impose restrictions on purchasers, the Court offers that the licensee may comply with this obligation by requiring its purchasers to sign a contract promising to abide by those restrictions.<sup>xx</sup> Having complied with the license, the licensee’s sale is authorized and therefore exhausts all patent rights in the item sold.<sup>xxi</sup> If the purchaser does not comply with the restrictions, the licensee may seek a remedy for breach of contract, but not patent infringement.<sup>xxii</sup>

The Court further clarified that its holding in *General Talking Pictures* does not stand for the proposition that patentees can use licenses to impose post-sale restrictions on purchasers, but stands rather for the principle that “if a patentee has not given authority for a licensee to make a sale, that sale cannot exhaust the patentee’s rights.”<sup>xxiii</sup> In *General Talking Pictures*, the licensee was authorized by the patentee to manufacture and sell the patented invention for private use only and was required to affix a notice to that effect to each product sold. Despite affixing the required notice to the product, the licensee nevertheless sold the product to a purchaser that the licensee knew intended to use the product commercially. The purchaser likewise had actual knowledge that the licensee did not have the authority to sell the products for commercial use. Further, both the licensee and the purchaser intended the notice affixed to the product to be disregarded.<sup>xxiv</sup> Accordingly, the Court determined that *both* the licensee and the purchaser infringed the underlying patent.<sup>xxv</sup>

In distinguishing *General Talking Pictures*, the Court seemed to rely heavily on the fact that both the licensee and purchaser had *knowledge* that the sale was outside the scope of the license at the time the sale was made. The Court stated that the facts of *Lexmark* were “fundamentally different” from the facts of *General Talking Pictures*, in which the licensee “‘knowingly made sales *outside* the scope of its license.”<sup>xxvi</sup> Consequently, the patentee in *General Talking Pictures* could sue “both the licensee and the purchaser—who *knew about the breach*—for infringement.”<sup>xxvii</sup> The Court explained this holding as follows: “The licensee infringed the patentee’s rights because it did *not* comply with the terms of its license, and the patentee could bring a patent suit against the purchaser only because the purchaser participated in the licensee’s infringement.”<sup>xxviii</sup>

## Exhaustion Based on Foreign Sales

The Court also reversed the Federal Circuit on the issue of international exhaustion, holding that *Lexmark*’s patent infringement claim fails with respect to cartridges subject to an initial authorized sale abroad and subsequently imported into the U.S.<sup>xxix</sup> The Court’s decision rejects the blanket rule adopted by the Federal Circuit in *Jazz Photo*<sup>xxx</sup> that foreign sales do not trigger exhaustion, and marks a new era in which an authorized sale exhausts all rights under the Patent Act in the item sold, regardless of the country wherein such sale occurred.<sup>xxxi</sup>

The Court’s decision brings patent law jurisprudence into conformity with recent evolutions in copyright law. The analogue to patent exhaustion under copyright law is the “first sale doctrine,” which is codified under 17 U.S.C. §109(a). The Supreme Court recently decided in *Kirtsaeng v. John Wiley & Sons, Inc.* that the “‘first sale’ [rule] applies to copies of a copyrighted work lawfully made [and sold] abroad.”<sup>xxxii</sup>

Noting the bond between patent law and copyright law, as well as the common law preference against restraints on the alienation of goods, the Court concluded that patent exhaustion should apply to foreign sales of patented goods just as copyright's first sale doctrine applies to foreign sales of copyrighted works.<sup>xxxiii</sup>

In reaching its decision, the Court rejected Lexmark's argument that "there is no patent exhaustion from sales abroad because there are no [U.S.] patent rights abroad to exhaust."<sup>xxxiv</sup> The Court explains that exhaustion is "a separate limit on the patent grant" and is triggered by the patentee's decision to sell the patented product, regardless of where the sale occurs.<sup>xxxv</sup>

### Implications of *Lexmark*

As a departure from Federal Circuit precedent, *Lexmark* broadens the scope of patent exhaustion. Ultimately, the following hard-and-fast rule can be taken away from *Lexmark*: "A patentee's decision to sell a product exhausts all of its patent rights in that item, regardless of any restrictions the patentee purports to impose or the location of the sale."<sup>xxxvi</sup> Parties engaged in licensing transactions should consider this case in structuring or potentially re-structuring those transactions. Additionally, defendants in patent litigation should review all relevant license agreements between the plaintiff and their suppliers and original equipment manufacturers to ascertain whether they may have a patent exhaustion defense in light of *Lexmark*.



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## ENDNOTES

- i 581 U.S. \_\_\_\_\_, No. 15-1189, slip op. (May 30, 2017).
- ii In *Quanta Computer, Inc. v. LG Electronics, Inc.*, 533 U.S. 617 (2008) the Supreme Court held that method claims can be exhausted and authorized sales of components that do not fully practice a patent can trigger exhaustion where the components include essential features of the patent and the reasonable and intended use of the components is to practice the patent. However, the Court in *Quanta* notably left open the issue of the types of “conditions” that could limit exhaustion in concluding that, despite the existence of post-sale restrictions, exhaustion applied because the licensee was authorized to sell products embodying the patents and “[n]o conditions limited [the licensee]’s authority to sell” those products. *Id.* at 637 (“Nothing in the License Agreement restricts [the licensee]’s right to sell . . .”).
- iii *Lexmark Int’l, Inc. v. Impression Prods., Inc.*, 816 F.3d 721 (Fed. Cir. 2016).
- iv *See Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992) (holding that a patentee may sell an item and retain the right to enforce, through patent infringement lawsuits, “clearly communicated, . . . lawful restriction[s] as to post-sale use or resale”).
- v *Lexmark*, slip. op. at 9.
- vi *Id.* at 9 (relying, in part, on *Quanta Computer, Inc.*, 533 U.S. 617).
- vii *Lexmark*, slip. op. at 13.
- viii *Id.* at 10 (citing *United States v. General Elec. Co.*, 272 U.S. 476, 489 (1926)).
- ix *Lexmark*, slip. op. at 10.
- x *Id.*
- xi *Id.*
- xii 304 U.S. 175, *aff’d on reh’g*, 305 U.S. 124 (1938).
- xiii *Lexmark*, slip op. at 11 (quoting *Lexmark*, 816 F.3d at 743-744).
- xiv *Lexmark*, slip op. at 11.
- xv *Id.*
- xvi *Id.*
- xvii *Id.*
- xviii *Id.* at 11-12.
- xix *Id.* at 12.
- xx *Id.*
- xxi *Id.*
- xxii *Id.*
- xxiii *Id.* at 12-13.
- xxiv *General Talking Pictures Corp.*, 304 U.S. at 180.
- xxv *Id.* at 182.
- xxvi *Lexmark*, slip op. at 12 (quoting *General Talking Pictures Corp.*, 304 U.S. at 181-82).
- xxvii *Lexmark*, slip op. at 12.
- xxviii *Id.*
- xxix *Id.* at 13.
- xxx *Jazz Photo Corp. v. Int’l Trade Commission*, 264 F.3d 1094 (Fed. Cir. 2001).
- xxxi *Lexmark*, slip op. at 13, 17.
- xxxii *Id.* at 13 (citing *Kirtsaeng v. John Wiley & Sons Inc.*, 568 U.S. 519, 525 (2013)).
- xxxiii *Lexmark*, slip op. at 13-15.
- xxxiv *Id.* at 15.
- xxxv *Id.* at 15-16.
- xxxvi *Id.* at 2.