masuda funai

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U.S. Supreme Court Narrows Patent Rights by Expanding Patent Exhaustion

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In another decision against patent owners, the U.S. Supreme Court has decided to expand the scope of the patent exhaustion doctrine.

The patent exhaustion doctrine provides that, when a patent owner sells a patented product, the patent rights in that item are exhausted and the patent owner no longer has the right to control further sale or use of that item through enforcement of its patent. In *Impression Products, Inc. v. Lexmark International, Inc*., 581 U.S. ____ (May 30, 2017), the Supreme Court expanded the doctrine in two ways:

1. In an unanimous decision, the Court decided that a patent owner cannot place post-sale restrictions on the sale of a product because all of the patent rights in a product are exhausted the moment the product is sold by the patent owner; and
2. In a 7-1 decision, the Court decided that foreign sales of a product by the patent owner also exhaust the patent owner's U.S. patent rights.

Factual and Procedural Background

The *Impression Products* case involved a dispute over toner cartridges used in laser printers. Lexmark designed, manufactured, and sold toner cartridges to consumers in the United States and around the world. Lexmark owned patents that covered certain aspects of the cartridges and the manner in which the cartridges were used. In selling the cartridges, Lexmark gave consumers the option to either (1) purchase the cartridge without any restrictions at full price or (2) purchase the cartridge at a discount through Lexmark's "Return Program" in exchange for the consumer's agreement to use the cartridge only once and return the empty cartridge only to Lexmark.

Impression Products was in the business of remanufacturing toner cartridges—which involves acquiring empty cartridges, refilling them with toner, and selling the refilled cartridges at a lower price than new cartridges. Impression Products remanufactured Lexmark's "Return Program" cartridges, as well as cartridges that had been sold by Lexmark outside of the U.S. It then sold both categories of remanufactured cartridges to consumers in the U.S. (at a discounted price).

Lexmark sued Impression Products—along with a number of other remanufacturers—for infringement of Lexmark's patents covering the toner cartridges. For the cartridges originally sold by Lexmark in the U.S. under the "Return Program," Lexmark alleged that the remanufacture and resale of those cartridges infringed its patents because reuse and resale was expressly prohibited by Lexmark. For all cartridges originally sold by Lexmark abroad, Lexmark alleged that the remanufacturers infringed Lexmark's patents by importing the cartridges into the U.S. because Lexmark never authorized anyone to import the cartridges. Impression Products argued that Lexmark's sales of the cartridges—both in the U.S. and overseas—exhausted Lexmark's patent rights in those cartridges and left Impression Products free to import, remanufacture, and resell them.

The district court agreed with Impression Products' exhaustion argument for the "Return Program" cartridges, but rejected the argument for the cartridges sold by Lexmark aboard. On appeal, the Federal Circuit held that Lexmark's patent rights in both groups of cartridges were not exhausted. For the "Return Program" cartridges, "the Federal Circuit held 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." *Impression Prods*., 581 U.S. ____, at 4 (internal quotations omitted). For the foreign-sale cartridges, the Federal Circuit held that foreign sales do not exhaust U.S. patent rights because "[e]xhaustion is justified when a patentee receives the reward available from [selling in] American markets, which does not occur when the patentee sells overseas, where the American patent offers no protection and therefore cannot bolster the price of the patentee's goods." *Id*. at 4-5 (internal quotations omitted).

The Supreme Court reversed the Federal Circuit as to both groups of cartridges, holding that, under the patent exhausting doctrine, Impression Products had not infringed Lexmark's patents.

<u>Post-Sale Restrictions Do Not Avoid Patent Exhaustion</u>

In holding that post-sale restrictions are invalid under the patent exhaustion doctrine, the Court relied on the common law principle disfavoring restraints on alienation. The Court explained that "[w]hen a patentee chooses to sell an item, that product is no longer within the limits of the [patent] monopoly and instead becomes the private individual property of the purchaser, with the rights and benefits that come along with ownership." *Id*. at 6 (internal quotations omitted). The Court noted that the principle of patent exhaustion has been recognized for over 160 years and that "[t]his well-established exhaustion rule marks the point where patent rights yield to the common law principle against restraints on alienation." *Id*. "The patent laws do not include the right to restrain[] . . . further alienation after an initial sale; such conditions have been hateful to the law from [the 17th century to the present] and are obnoxious to the public interest." *Id*. at 7 (internal quotations and citations omitted). The Court further noted that "extending the patent rights beyond the first sale would clog the channels of commerce with little benefit from the extra control that the patentees retain." *Id*. at 7-8. "Patent exhaustion reflects the principle that when an item passes into commerce, it should not be shaded by a legal cloud on title as it moves through the marketplace." *Id*. at 11.

Thus, the Supreme Court held that Lexmark's single-use/no-resale restrictions in the "Return Program" contracts did not entitle Lexmark to retain patent rights in the cartridges. *Id*. at 5. The Court noted that Lexmark might have a remedy in contract law, but, once it sold the items into commerce, it lost any relief under patent law.

The Court also addressed the issue of imposing restrictions through the use of licenses. The Court first recognized that a "patentee can impose restrictions on licensees because a license does not implicate the same concerns about restraints on alienation as a sale . . . a license is not about passing title to a product, it is about changing the contours of the patentee's monopoly: The patentee agrees not to exclude a licensee from making or selling the patented invention, expanding the club of authorized producers and sellers. . . . Because the patentee is exchanging rights, not goods, it is free to relinquish only a portion of its bundle of patent protections." *Id*. at 11.1

The Court then cautioned that a "patentee's authority to limit *licensees* does not . . . mean that patentees can use licenses to impose post-sale restrictions on *purchasers* that are enforceable through the patent laws." *Id*. In other words, an indirect sale through a licensee—wherein the patentee grants the licensee permission to make and sell the product but requires the licensee to impose a restriction on purchasers—would also exhaust the patent rights and preclude enforcement of the restriction under patent law against the purchaser if the purchaser did not comply with the restrictions. "[The] licensee's sale is treated, for purposes of patent exhaustion, as if the patentee made the sale itself." *Id*. at 12. However, the Court seemed to imply that if a licensee made sales outside of the scope of the license—for example, by not complying with the terms of the license—then the patentee might have a patent law remedy against the licensee and the downstream purchases "who knew about the breach." *Id*.

<u>Foreign Sales Exhaust U.S. Patent Rights</u>

In analyzing whether patent exhaustion should apply to products initially sold outside the U.S., the Court was guided by its recent copyright decision in *Kirtsaeng v. John Wiley & Sons, Inc*., 568 U.S. 519 (2013)—where the Court decided that the first sale doctrine under copyright law applied to sales of copyrighted materials sold abroad. The first-sale doctrine for copyrights is codified in 17 U.S.C. § 109 and provides that a copyright owner loses the right to restrict a purchaser's ability "to sell or otherwise dispose of . . . that copy" when the copyright owner makes a lawful sale of a copy of its work. Unlike the first-sale doctrine, patent exhaustion is not codified, "it remains an unwritten limit on the scope of the patentee's monopoly." *Impression Prods*., 581 U.S. ____, at 14.

Despite this distinction, the Court noted the "kinship between patent law and copyright law" and further determined that "differentiating the patent exhaustion and copyright first sale doctrines would make little theoretical or practical sense: The two share a strong similarity . . . and identity of purpose." *Id*. (internal quotations omitted). It was not the language of the first-sale statute that mattered in *Kirtsaeng*; "[w]hat helped tip the scales for global exhaustion [of copyright protection] was the fact that the first sale doctrine originated in the common law's refusal to permit restraints on the alienation of chattels . . . [and t]hat common-law doctrine makes no geographical distinctions." *Id*. (internal quotations and citations omitted). The Court noted that "[p]atent exhaustion, too, has its roots in the antipathy toward restraints on alienation . . . and nothing in the text or history of the Patent Act shows that Congress intended to confine that borderless common law principle to domestic sales." Accordingly, the Court held that the principle of international exhaustion should apply equally to patents as it does to copyrights.

However, Lexmark argued that the territorial limits on patent rights should limit the applicability of the patent exhaustion doctrine. Lexmark reasoned that a "domestic sale . . . triggers exhaustion because the sale compensates the patentee for surrendering [its] *U.S.* rights" and that "a patentee selling in a foreign market may not be able to sell its product for the same price that it could in the United States, and therefore is not sure to receive the reward guaranteed by U.S. patent law." *Id*. at 15 (internal quotations and citations omitted)(emphasis in original). In other words, like the Federal Circuit, Lexmark believed that U.S. patent protection should allow it to "bolster the price of the patentee's goods" in the U.S. *Id*. at 5.

The Court was not persuaded by Lexmark's argument. Instead, it noted that "the Patent Act does not guarantee a particular price, much less the price from selling to American consumers . . . [i]nstead, the right to exclude just ensures that the patentee receives one reward—of whatever amount the patentee deems to be satisfactory compensation—for every item that passes outside the scope of the patent monopoly." *Id*. at 15-16 (internal quotations and citations omitted).

Thus, the Court ultimately concluded, "[a]n authorized sale outside the United States, just as one within the United States, exhausts all rights under the Patent Act." *Id*. at 13.

<u>Takeaways and Practice Notes</u>

While the Court's decision expands the scope of patent exhaustion, it does not leave patentees completely without recourse to enforce post-sale restrictions. The Court's ruling only prohibits enforcement of post-sale restrictions under the patent laws. The Court explicitly left open the possibility for a cause of action under contract law—assuming, of course, a valid contract exists between the patentee and purchaser. Patent owners looking to impose post-sale restrictions should review the terms of their sales contacts to ensure that those restrictions are adequately addressed and supportable under the *Impression Products* decision.

Furthermore, the Court's ruling is limited to exhaustion of patent rights in a *sale* of the product. The Court distinguished sales from licenses and recognized that a patentee can impose restrictions on licensees. Patent owners looking to impose restrictions on the use of their products may improve the likelihood that their patent rights will not be found to be exhausted if they structure the transaction as a license to the consumer to use the product as opposed to an outright sale of the product.

Lastly, the Court's finding of global exhaustion may lead to a surge of grey market goods entering the U.S. market and changes to the prices of patented products. In the patent context, grey market goods are products that are legitimately sold by the patent owner in foreign markets and which are not intended for the U.S. market. Often times, grey market goods are sold by the patentee at lower prices in foreign markets than in the U.S. In view of the Court's ruling, patentees can no longer use their patent rights to prevent third parties from importing these grey market goods and reselling them in the U.S. at a price that undercuts the patentee. The effect of this practice, likely will lead patentees to either (1) lower the prices of their products in the U.S. so as not to be undercut by grey market goods entering the U.S. market or, more likely, (2) increase prices of goods in the foreign markets to prevent third parties from profiting on the price differentials through re-exportation back to the U.S.

[1] Notably, while the Court specifically referenced licenses for making or selling the invention, it made no mention of licenses for use of the invention. This raises the question of whether a patent owner can avoid patent exhaustion by granting the end consumer an individual use license (for example, a shrink wrap license) in exchange for a paid-up royalty, instead of outright selling the product. This question similarly applies to the effect of the first-sale doctrine under copyright law on shrink-wrap licenses for copyrighted work.